Bankruptcy Law and Practice

Fourth Edition

A Free Law School Casebook

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BANKRUPTCY LAW AND PRACTICE

A Casebook Designed to Train Lawyers for the Practice of Bankruptcy Law
Fourth Edition

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About the Author

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Notices

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Purpose of Textbook

This book is intended for a three credit law school course covering the fundamentals of bankruptcy law and practice. Students should recognize that this is a "Code" class, and that the starting place for solving most bankruptcy problems is the Bankruptcy Code itself. Students should read the materials and work through the problems by direct reference to the provisions of the Bankruptcy Code. Bankruptcy lawyers simply must be comfortable with the Code in order to be effective.

The book contains many cases interpreting the Bankruptcy Code. The cases have been stripped to the essentials to minimize reading. Most cross-citations have been deleted. Issues discussed in the cases that are not relevant to the point for which the case is included in the materials have been stricken. Bolding has been added to important language the students should focus on. The practitioner, of course, should always read full cases and not rely on the edited versions in this book or on headnotes or other secondary sources. This book contains the bones of the case, with flesh left only where essential to understanding the court's reasoning on the particular issue of relevance to the material in the book.

Much of the learning will come through working with the problems. Many students have developed the bad practice of reading the questions without trying to solve them. Don't do that. You need to try to solve the problems by reading and working through the statute. The best way to learn and be comfortable with using the statutory language is to work through the statute to solve the problems.

Some of the problems contain case references. I do not expect my students to read the cases that are merely cited in the problems, and not reprinted in the book. I discuss some of these cases with the class when covering the problems. Students interested in the problems are always free to read the cases for greater understanding, as time permits.

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Chapter 1. A World Without Bankruptcy

1.1. A Wee Bit of History

We begin the study of bankruptcy law by imagining a world in which bankruptcy does not exist. That was in fact the state of affairs during most of the 18th and 19th centuries. While the Constitution gave Congress the power to "establish uniform laws on the subject of bankruptcies," it did not require Congress to enact bankruptcy laws. U.S. Constitution, Article I, Section 8, Clause 4. There were short-lived federal bankruptcy laws in effect from 1800-1803, 1841-1843, and 1867-1878. Federal bankruptcy law only became permanent with the passage of the 1898 act, which remained in effect (with substantial revisions) until the passage of the current bankruptcy code in 1978. The 1898 Act, as amended, remains known as the "Bankruptcy Act," and the 1978 law is known as the "Bankruptcy Code."

Early bankruptcy laws both internationally and in the United States were primarily methods for creditors to join together to efficiently collect their debts. There were no voluntary bankruptcy cases filed by debtors until the late 19th Century - bankruptcy cases could only be commenced by creditors filing involuntary petitions against debtors who were in default. In the early days, debtors who were unable to pay their debts were sent to languish in prison until their debts were paid. For most, this was a life sentence – only those fortunate enough to have family members able to pay could buy their freedom. The original concept of a "discharge" was a release from prison given by creditors to cooperative debtors, not the modern concept which bans creditors from attempting to collect the discharged debts. Debtors prisons were abolished in the middle of the 19th century, but some vestiges remained well into the middle of the 20th century, when the Supreme Court finally made it clear that debtors could not constitutionally be imprisoned for their inability to pay debts. *See* *Williams v. Illinois*, 399 U.S. 235 (1970); *Tate v. Short*, 401 U.S. 395 (1971). Note that debtors can still today be imprisoned for refusing to pay debts that the debtor is able to pay – generally on a finding of contempt for disobeying a turnover order. We begin therefore with the process by which debts are collected outside of bankruptcy.

1.2. Enforcing Claims

An unsecured claim arises from a debtor's legal obligation to pay money or property to a creditor. The legal obligation can be created by a debtor's promise to pay money or deliver property to a creditor (contract), from a debtor's receipt of money or property under circumstances requiring restitution (quasi-contract), or from a debtor's commission of a tort.

It is important to distinguish unsecured claims from secured claims, which will be discussed in Chapter 2. A secured claim arises when a debtor voluntarily gives a lien on some or all of the debtor's property to secure repayment of the debt (consensual lien), or when the law imposes a lien on debtor's property to secure repayment of the debt (involuntary lien). In order for a lien to exist, there must be some specific property that is subject to the lien. A lien is a creditor's legal right, "in rem," to enforce a claim against specific property owned by the debtor upon default. A lien is an interest in the property itself, and must be distinguished from the unsecured, "in

personam," right that the creditor has against the debtor. We will start with a review of the system for collecting unsecured claims that are based on the borrower's legal obligation to pay, and then we will look at the creation, enforcement and priority of secured claims or liens in Chapter 2.

1.3. The Self-Help System for Collecting Unsecured Claims

At one time creditors were permitted to use violence and enslavement to collect their claims. In medieval times, the law even assisted creditors by allowing pillory, under which debtors were restrained and subjected to maiming and death at the hands of their creditors. That is no longer the case. It is a crime in every state to threaten to or use violence to collect debts. Short of violence and threats of violence, however, the state laws on debt collection are ill defined and poorly enforced. Creditors are generally free to call or visit their debtors to ask for payment, to report defaults to credit bureaus (which can result in the modern equivalent of a scarlet letter), and even to engage in various forms of conduct that many would consider to be harassment. The limitations are generally embodied in criminal laws like extortion, although some states have enacted fair collection statutes modeled after the federal Fair Debt Collection Practices Act, but applied to the creditors themselves rather than to third party debt collectors. There are also general consumer protection statutes that provide some protection for debtors, but these tend to apply only to specific industries and practices.

The main uniform limitation on debt collection activities is the federal Fair Debt Collection Practices Act. The first thing to note about the Act is that it generally applies only to debt collectors – those who regularly collect debts owed to another. It is entirely inapplicable to creditors who collect their own debts in their own names, and to the collection of business debts. Nevertheless, the act is extremely important because creditors often utilize third party debt collectors to collect consumer debts. The debt collection industry is enormous – it is a multi-billion dollar industry – and its practitioners range from professional law firms to sleazy boiler room operations. In most states, no license or professional training is required to engage in the debt collection industry, and violations of the federal Act abound.

1.3.1. Practice Problems: Fair Debt Collection Practices Act (FDCPA)

Read the Fair Debt Collection Practices Act (FDCPA), 15 U.S.C. 1601 et seq, which is reprinted in Appendix A at the end of the book. If you are using an electronic version of this book, you should be able to click any of the underlined links to take you directly to the relevant appendix or code section in this document. If you have internet access, you should also be able to click case links to read the full text version of the cited case using the free Google Scholar service.

Problem 1. Debtor owes $15,000 on her BofA Visa card, and has not made a payment in two months. A BofA employee calls the Debtor at 2:00 in the morning, and allows the phone to ring 10 times before it is answered. The employee tells the debtor that he is an employee of BofA, and threatens to have the debtor put in jail unless payment is made by the close of business that day. What provisions of the FDCPA have been violated? FDCPA § 803(6).

Problem 2. How would your answer to Problem (1) change if the BofA employee falsely told the debtor that he worked for the district attorney's office? *See* FDCPA § 803(6)(A).

Problem 3. You are a new lawyer working at a debt collection law firm. Your firm has been asked to collect a debt owing to Bank of America. You want to send a demand letter to the debtor offering to accept 80% of the debt for immediate payment. If the 80% is not paid within 10 days, you want the debtor to know that you will file suit and seek to recover attorney fees and costs under the agreement. Are you subject to the FDCPA? *See* FDCPA § 803(6). If so, what must you say in the letter? *See* FDCPA §§ 807(11), 809. For example, may you say (1) that you are an attorney, and (2) that you intend to file suit if the debtor does not timely accept your 80% payment offer? *See* FDCPA § 807.

Problem 4. Assume the same facts as in Problem (3), except that the debtor borrowed money for its business rather than owing money on a credit card. Would this change any of your answers? *See* FDCPA § 803(5).

Problem 5. You are now the debtor. You have received a letter from an attorney like the one in Problem (3). You have no idea what this debt is, and believe it may be a mistake or identity theft. What should you do? *See* FDCPA § 809(b). What must the debt collector do in response to your action?

Problem 6. Assume that the debtor owes the debt, but does not have the money to pay it, and is tired of getting collection calls constantly. What can the debtor do to stop the calls? *See* FDCPA § 805(c).

Problem 7. What can an individual consumer recover in an action against a collector for violating the FDCPA? *See* FDCPA § 813.

Problem 8. The statute of limitations is an affirmative defense to an action filed by a creditor to collect a debt after the statutory period has expired. Is it a violation of the FDCPA for an attorney representing a creditor to file a collection action after the statutory period has expired? Is it a violation of the FDCPA for the attorney or a debt collector to file a proof of claim in a bankruptcy proceeding on a debt that is time barred under the statute of limitations? *Midland Funding, LLC v. Johnson*, 581 US ___ (2017).

Problem 9. Your client owes $10,000 to Citicorp on a credit card, and has not made payments for over a year. After failing to collect the debt, Citicorp sold the debt (along with many other debts that were in default) to Santander Bank. Is Santander Bank liable under the FDCPA if it violates the statutory provisions? Consider both (1) whether Santander is a "debt collector" under FDCPA § 803(6), and (2) whether Santander is a "creditor" under FDCPA § 803(4)?

1.3.2. HENSON v. SANTANDER CONSUMER USA INC., 582 U.S. (June 12, 2017)

JUSTICE GORSUCH delivered the opinion of the Court.

Disruptive dinnertime calls, downright deceit, and more besides drew Congress's eye to the debt collection industry. From that scrutiny emerged the Fair Debt Collection Practices Act, a

statute that authorizes private lawsuits and weighty fines designed to deter wayward collection practices.

So perhaps it comes as little surprise that we now face a question about who exactly qualifies as a "debt collector" subject to the Act's rigors. Everyone agrees that the term embraces the repo man—someone hired by a creditor to collect an outstanding debt. But what if you purchase a debt and then try to collect it for yourself— does that make you a "debt collector" too? That's the nub of the dispute now before us. The parties approach the question from common ground. The complaint alleges that CitiFinancial Auto loaned money to petitioners seeking to buy cars; that petitioners defaulted on those loans; that respondent Santander then purchased the defaulted loans from CitiFinancial; and that Santander sought to collect in ways petitioners believe troublesome under the Act. The parties agree, too, that in deciding whether Santander's conduct falls within the Act's ambit we should look to statutory language defining the term "debt collector" to embrace anyone who "regularly collects or attempts to collect . . . debts owed or due . . . another." 15 U. S. C. §1692a(6). Even when it comes to that question, the parties agree on at least part of an answer. Both sides accept that third party debt collection agents generally qualify as "debt collectors" under the relevant statutory language, while those who seek only to collect for themselves loans they originated generally do not. These results follow, the parties tell us, because debt collection agents seek to collect debts "owed . . . another," while loan originators acting on their own account aim only to collect debts owed to themselves. All that remains in dispute is how to classify individuals and entities who regularly purchase debts originated by someone else and then seek to collect those debts for their own account. Does the Act treat the debt purchaser in that scenario more like the repo man or the loan originator? [The Court then recognizes a split between the circuit courts which it must resolve]. Before attending to that job, though, we pause to note two related questions we do not attempt to answer today.

First, petitioners suggest that Santander can qualify as a debt collector not only because it regularly seeks to collect for its own account debts that it has purchased, but also because it regularly acts as a third party collection agent for debts owed to others. Petitioners did not, however, raise the latter theory in their petition for certiorari and neither did we agree to review it. Second, the parties briefly allude to another statutory definition of the term "debt collector"—one that encompasses those engaged "in any business the principal purpose of which is the collection of any debts." §1692a(6). But the parties haven't much litigated that alternative definition and in granting certiorari we didn't agree to address it either. With these preliminaries by the board, we can turn to the much narrowed question properly before us. In doing so, we begin, as we must, with a careful examination of the statutory text. And there we find it hard to disagree with the Fourth Circuit's interpretive handiwork. After all, the Act defines debt collectors to include those who regularly seek to collect debts "owed . . . another." And by its plain terms this language seems to focus our attention on third party collection agents working for a debt owner— not on a debt owner seeking to collect debts for itself. Neither does this language appear to suggest that we should care how a debt owner came to be a debt owner— whether the owner originated the debt or came by it only through a later purchase. All that matters is whether the target of the lawsuit regularly seeks to collect debts for its own account or does so for "another." And given that, it would seem a debt purchaser like Santander may indeed collect debts for its own account without triggering the statutory definition in dispute, just as the Fourth Circuit explained. [The Court then rejects Petitioner's argument that "owed" is a past participle that would not apply to purchased debts].

Elsewhere, Congress recognized the distinction between a debt "originated by" the collector and a debt "owed or due" another. §1692a(6)(F)(ii). And elsewhere still, Congress drew a line between the "original" and "current" creditor. §1692g(a)(5). Yet no similar distinction can be found in the language now before us. To the contrary, the statutory text at issue speaks not at all about originators and current debt owners but only about whether the defendant seeks to collect on behalf of itself or "another."

Even what may be petitioners' best piece of contextual evidence ultimately proves unhelpful to their cause. Petitioners point out that the Act exempts from the definition of "debt collector" certain individuals who have "obtained" particular kinds of debt—for example, debts not yet in default or debts connected to secured commercial credit transactions. §§1692a(6)(F)(iii) and (F)(iv). And because these exemptions contemplate the possibility that someone might "obtain" a debt "owed or due . . . another," petitioners submit, the word "owed" must refer only to a previous owner. This conclusion, they say, necessarily follows because, once you have "obtained" a debt, that same debt just cannot be currently "owed or due" another.

This last and quite essential premise of the argument, however, misses its mark. As a matter of ordinary English, the word "obtained" can (and often does) refer to taking possession of a piece of property without also taking ownership. You might, for example, take possession of a debt for servicing and collection even while the debt formally remains owed another. Or as a secured party you might take possession of a debt as collateral, again without taking full ownership of it. So it simply isn't the case that the statute's exclusions imply that the phrase "owed . . . another" must refer to debts previously owed to another. By this point petitioners find themselves in retreat. On their view, debt purchasers surely qualify as collectors at least when they regularly purchase and seek to collect defaulted debts—just as Santander allegedly did here. [U]nder the definition at issue before us you have to attempt to collect debts owed another before you can ever qualify as a debt collector. And petitioners' argument simply does not fully confront this plain and implacable textual prerequisite.

Likewise, even spotting (without granting) the premise that a person cannot be both a creditor and a debt collector with respect to a particular debt, we don't see why a defaulted debt purchaser like Santander couldn't qualify as a creditor. For while the creditor definition excludes persons who "receive an assignment or transfer of a debt in default," it does so only (and yet again) when the debt is assigned or transferred "solely for the purpose of facilitating collection of such debt for another." Ibid. (emphasis added). So a company collecting purchased defaulted debt for its own account—like Santander— would hardly seem to be barred from qualifying as a creditor under the statute's plain terms.

[Petitioners then argue that] had Congress known this new [debt collection] industry would blossom, they say, it surely would have judged defaulted debt purchasers more like (and in need of the same special rules as) independent debt collectors. Indeed, petitioners contend that no other result would be consistent with the overarching congressional goal of deterring untoward debt collection practices.

All this seems to us quite a lot of speculation. And while it is of course our job to apply faithfully the law Congress has written, it is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have done had it faced a question that, on everyone's account, it never faced.

In the end, reasonable people can disagree with how Congress balanced the various social costs and benefits in this area. We have no difficulty imagining, for example, a statute that applies the Act's demands to anyone collecting any debts, anyone collecting debts originated by another, or to some other class of persons still. Neither do we doubt that the evolution of the debt collection business might invite reasonable disagreements on whether Congress should reenter the field and alter the judgments it made in the past. After all, it's hardly unknown for new business models to emerge in response to regulation, and for regulation in turn to address new business models. Constant competition between constable and quarry, regulator and regulated, can come as no surprise in our changing world.

But neither should the proper role of the judiciary in that process—to apply, not amend, the work of the People's representatives. The judgment of the Court of Appeals is affirmed.

1.4. The Judicial System for Collecting Unsecured Claims – Obtaining and Enforcing a Judgment

In order to collect an unsecured debt using the judicial process, an unsecured creditor must file a lawsuit against the debtor, win the suit by obtaining a money judgment from the court, and then enforce the judgment against the debtor's property. The process for obtaining a money judgment can be long and expensive if the debtor files an answer to the complaint. Fortunately for creditors in consumer cases, most debtors do not have the knowledge (or financial ability to hire someone with the knowledge to represent them) to file an answer to the complaint. If an answer is not timely filed after service, the creditor can obtain a fast and cheap default judgment, and can then proceed to enforce that judgment.

The lawsuit process is slowed down considerably if the defendant/debtor files an answer to the complaint. The creditor must either win the suit by summary judgment or prove the case at trial – a process that can take years in many jurisdictions and can be extremely costly. In New York, collection firms often let the suit languish or drop the suit entirely if the debtor merely files an answer to the complaint, because it is simply not worth the money for a creditor in a small consumer case to have to prove the claim. I advise debtors to always file an answer to a complaint, even if they have no real defenses. There is nothing wrong with making a creditor prove its case. Unfortunately, by the time debtors seek legal assistance, they are usually facing the loss of property, and have often waived legitimate defenses by failing to file a timely answer.

After the creditor recovers a money judgment (usually by default, or after summary judgment or trial), the creditor can apply to the clerk of the court for a writ of execution or something similar (in the old days it was called a "writ of fieri facias" or "fi fa," and it is still called that in some jurisdictions). The writ by whatever name is used in the state instructs the levying officer (usually the County Sheriff) to recover and sell the identified property to satisfy the creditor's judgment. The creditor must identify property owned by the judgment debtor that is available for execution, and provide the levying officer with the location of the property.

In order to determine what property is available for execution, the creditor after obtaining a judgment can take discovery from the debtor to determine the existence and location of the judgment debtor's non-exempt property. In small cases this is done by written interrogatory – in

larger cases this is done by oral examination (deposition). Creditors can also discover the location of assets using governmental and database searches, or from information provided by the debtor when the original credit was extended.

Upon receipt of the writ of execution, the levying officer must drive his or her pickup truck to the location of the property, physically seize the property (using force if necessary), bring the property back to the levying officer's place of business, and proceed to follow a statutory procedure for selling the property (normally through an advertised auction process). The proceeds from the auction sale are used to pay first the levying officer's costs of execution and then the creditor's claim. Any excess is returned to the debtor.

The process is slightly different for real property, since the levying officer cannot put land in the back of a pickup truck. The levy on real property is generally made by the levying officer posting some sort of notice that the land is being seized. Some states require other symbolic acts by the levying officer, such as grabbing some soil and saying a magic incantation in addition to posting the notice of levy. Following levy, a similar sale procedure is utilized to sell real property.

1.5. Provisional Remedies

Provisional remedies are prejudgment remedies that can be issued by a court to preserve the status quo during the lawsuit. Traditional prejudgment remedies are preliminary injunctions, provisional receiverships pending foreclosure, and prejudgment writs of attachment. Under a pre-judgment writ of attachment, the levying officer would hold and protect the property pending the final outcome of the case.

At one time, state statutes allowed creditors to recover collateral or obtain prejudgment attachment and garnishment using court process without prior notice to the judgment debtor, and without requiring proof to the satisfaction of a judge. Indeed, often defendants could be deprived of the possession of property based on nothing more than an attorney's allegation.

Beginning in the 1970s, the Supreme Court struck down a number of state provisional remedy statutes for failing to provide Debtors with due process prior to allowing their property to be taken. *See* *Sniadach v. Family Fin. Corp. of Bay View*, 395 U.S. 337 (1969) (striking down prejudgment wage garnishment statute); *Fuentes v. Shevin*, 407 U.S. 67 (1972) (striking down statutes allowing prejudgment replevin without notice and without a judicial hearing), *Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974) (allowing prejudgment replevin without notice but only after a judicial hearing and with the posting of a substantial bond to protect the debtor); *North Georgia Finishing, Inc. v. Di-Chem, Inc.* 419 U.S. 601 (1975) (striking down prejudgment garnishment statute); and *Connecticut v. Doehr*, 501 U.S. 1 (1991) (striking down statute allowing prejudgment attachment of real estate without prior notice or hearing and without posting a bond).

I read these cases to require unsecured creditors to give their debtors notice of the proceeding and an opportunity to appear and object before debtors can be deprived of the possession and control of their property, unless the creditor can prove to the judge's satisfaction that the property will likely be lost if prior notice is given. Even after meeting a heavy showing of necessity, the creditor must be required to post a bond to protect the debtor from financial loss

should the creditor not prevail, and the debtor must be given the opportunity for a prompt post-deprivation hearing.

The reason that there have been so few published cases involving *ex parte* (that is, without notice) pre-judgment writs is that state courts no longer grant *ex parte* relief except upon the most extraordinary showing of cause. Your author once tried to get a California state court to issue a prejudgment writ of attachment upon a substantial showing that the defendant was hiding assets that would likely be dissipated if notice was given. The judge denied the application without even offering me a hearing, saying that this kind of relief "just isn't granted anymore." While there may be courts in less liberal parts of the country that would entertain *ex parte* relief, the burden of proof on the applying creditor will likely be heavy.

Prejudgment remedies are available on notice, but the required showing is heavy. The creditor must show a probability of success on the merits, a likelihood of harm during the pendency of the case if relief is not granted, and must post a bond to protect the defendant from loss should the debtor ultimately prevail on the merits. Even though their role has been diminished, prejudgment remedies have an important role to play in the race between creditors to the court house that is discussed later in this chapter.

1.6. Cases on The Sheriff's Duty to Enforce Writs

1.6.1. DAVID J. VITALE v. HOTEL CALIFORNIA, INC., 184 N.J. Super 512, 446 A.2d 880 (1982)

Plaintiff David J. Vitale, Jr. brings this motion pursuant to N.J.S.A. 40A:9-109 to amerce, that is, hold liable the Sheriff of Monmouth County, William Lanzaro, for failing to execute a writ based on a judgment against defendant Hotel California, Inc. (California). The chronology of events is as follows: Vitale obtained a final judgment against California in the amount of $6,317 plus costs on August 12, 1980 and thereafter learned that California held the liquor license for "The Fast Lane," a bar featuring "punk rock" entertainers, located in Asbury Park, New Jersey. A writ of execution issued on June 23, 1981, and on July 9 the sheriff received the writ along with a cover letter from plaintiff instructing him to levy upon all monies and personal property at The Fast Lane.

Then began plaintiff's travail with the sheriff's office which gave rise to this proceeding. On July 27 the office indicated to plaintiff's attorney that a levy was not possible since the bar was only open late in the evening, from about 10 p.m. to 2 a.m., and that the writ would be returned unsatisfied. [Plaintiff's attorney] advised a deputy sheriff that it was absolutely necessary to proceed to make the levy during the open hours.

[The sheriff reported that he] went to The Fast Lane on July 31 accompanied by an Asbury Park police officer, identified himself and announced his purpose at the door, but was denied access by the bar's "bouncers." Fearing that violence might ensue, the officers left. [Plaintiff's attorney advised the sheriff] to make the levy and arrest anyone interfering with execution. [The sheriff refused to proceed without a further court order, which the plaintiffs obtained. The sheriff] went [to the bar] on the morning of August 15 and was able to seize $714 in cash and other personal

property. [The sheriff] reported back . . . his belief that additional money may have been secreted before he was able to levy upon it. [The Sheriff refused to make further levies contending] that only one levy need be made under a writ of execution.

The sheriff maintains that "it is unreasonable to expect any Sheriff, to command his officers or deputies to go forth on an unknown number of occasions, at an unreasonable hour, to seize proceeds of an establishment such as The Fast Lane."

Three basic, interrelated questions are presented for resolution: (1) Are successive levies possible under one writ of execution? (2) When may a sheriff refuse to levy as instructed by a plaintiff, on the basis that the request is unreasonable or onerous? (3) Was the conduct of Sheriff Lanzaro and his office in respect to the writ such as to subject him to amercement?

Before proceeding to answer the first question, a brief overview of execution procedure would be beneficial. A successful plaintiff who obtains a judgment against a defendant may cause the personal property of the defendant/judgment debtor to be seized and sold and the proceeds applied to the judgment and costs by way of execution. To do this, plaintiff obtains a writ of execution, directing the sheriff to levy and make a return within three months after the date of issuance. (A "return" is the physical return of the original writ to the court clerk, endorsed with the executing officer's brief description of what was done. In addition, the officer must file a verified statement of when and how much money was collected and the balance due on execution fees or costs.).

The writ may be returned before the return date if, notwithstanding diligent effort, the judgment cannot be satisfied any further. Once an execution has been returned, a sheriff cannot thereafter levy upon any property under the writ. Nor can a valid levy be made after the return date. Successive executions upon the same judgment are possible. Therefore, if the first seizure is insufficient, the creditor may seek an alias writ for levy upon other goods. Thereafter, the plaintiff may seek an unlimited number of pluries writs until the judgment is satisfied. The proceeds from the sheriff's sale of seized property are paid to the judgment creditor or to his or her attorney or to the court clerk.

Throughout the process plaintiff plays a crucial role. Plaintiff must prepare the writ, have it entered by the court clerk and see that it is delivered to the sheriff with instructions as to levying. If necessary, plaintiff should conduct discovery to locate and identify property to be levied upon. Complementary to plaintiff's responsibility is the sheriff's duty to execute the writ according to the plaintiff's instructions. The writ is in the "exclusive control" of the judgment creditor; the sheriff must follow the creditor's reasonable instructions regarding the time and manner of making the levy and must abide by special instructions to make an immediate levy, if practicable, when plaintiff demonstrates necessity.

I. Successive Levies Under One Writ

The first question presented, whether successive levies can be made under one writ, can be simply answered — "yes." . . . . If property levied on is not sufficient to satisfy the execution, a return should not be made without a showing that attempting another levy would be fruitless.

II. Reasonableness of Requested Levies

That brings us to the second question, whether the sheriff rightly refused to honor an unreasonable request to levy. The particular elements of the request perceived as unreasonable must be reviewed.

The sheriff first objects to the "unknown number of occasions" that he and his deputies would have to go forth to attempt levy in order to comply with plaintiff's wishes. There is technically no limit to the number of times that a sheriff might be required to levy. Nevertheless, practical, operational considerations of a sheriff's office impose an obligation on a plaintiff not to request inordinately frequent and numerous levies. The one successful levy netting $714 on August 15 can be used to project what was entailed by plaintiff's request for levies on successive weekend nights. By extrapolation, the sheriff might have had to levy approximately nine times in the space of one to two months to comply with the request. This many potential levies under one judgment may be unusual but is not in itself unreasonable.

The objection as to the unreasonably late hour requested for the levy also cannot be sustained. Levy under a writ of execution may be made at any hour of the day; there is no issue of privacy here that might dictate otherwise. The Fast Lane's late open hours impelled the late-at-night levy. Like police officers, sheriffs and their deputies may be obliged to work at times of the day and week when the rest of the populace sleep or recreate.

The threat of violence engendered by attempting the levy goes to the heart of the sheriff's objections. "[T]o seize proceeds of an establishment such as The Fast Lane" un-camouflages what may have been the most unappetizing aspect of the requested levy. (Emphasis supplied). . . . Nevertheless, the refusal to make further levies implies that a conscious decision may have been made to risk amercement rather than further confrontations at the bar.

When is physical force appropriate in making a levy? The general rule is that:

> [an] officer may force an entry into any enclosure except the dwelling house of the judgment debtor in order to levy a *fieri facias* on the debtor's goods and even in the case of the debtor's home, when the officer is once inside, he may break open inner doors or trunks to come at the goods.

On July 31 The Fast Lane bouncers did in fact, obstruct the officer from "performing an official function by means of intimidation," giving the officers probable cause to arrest them. Their resistance to the lawful process might have been a basis for criminal conviction. Although the officers did not believe themselves to be in a position to use physical force, they apparently did not summon back-up help to effectuate the levy or make arrests incidental thereto.

Are sheriffs' deputies to be faulted for not using physical force in a nonemergency situation? The nature of law is to physically force people, if need be, to do things or refrain from doing things that they would be free to do or not do in the "natural state"; the hope is that the benefit to society will more than compensate for the loss of individual freedom. Sheriff's officers act as the physical extension of the power of the court, and thus, of the law and the will of the people. Necessarily, then, the privilege of such civil service occasionally demands risking bodily harm to oneself. Only in this way will the lawless be kept from becoming the de facto law makers. Philosophy aside, the record is barren of facts showing any imminent harm to the sheriff's officers on July 31 other than the vague averment that attempting to carry out the levy may have triggered a violent reaction. I find this unembellished defense insufficient to justify not making the levy.

III. Amercement

Consequently, by concluding that the sheriff failed to abide by plaintiff's proper requests to levy, I reach the question of amercement. By proceeding in amercement, a judgment creditor may hold a sheriff liable for failing to properly execute against a judgment debtor:

If a sheriff or acting sheriff fails to perform any duty imposed upon him by law in respect to writs of execution resulting in loss or damage to the judgment creditor, he shall be subject to amercement in the amount of such loss and damage to and for the use of the judgment creditor. The delinquent sheriff or acting sheriff shall also be subject to attachment or punishment for contempt.

The cases demonstrate uniform application of the principle that a "sheriff is not liable to amercement until he shall have disobeyed positive, reasonable, lawful directions." From the above discussion it is clear that plaintiff has carried his burden. Plaintiff's instructions were consistent and direct and the successive levies requested were lawful and reasonable under the circumstances. The sheriff understood but did not comply with those instructions. Insofar as potential physical resistance thwarted the levy on July 31 and may have inhibited further levies after August 15, there was a definite failure to perform a duty with regard to an execution. It is not denied that plaintiff repeatedly expressed a willingness to pay the mileage costs and fees associated with the levies. The sheriff's failure to abide by plaintiff's instructions therefore renders him liable to be amerced.

The final issue is whether plaintiff has demonstrated a loss. Plaintiff must show that the officer's conduct has deprived him of a "substantial benefit to which he was entitled" under the writ; that but for the officer's conduct, he would have received such benefit through the execution. Plaintiff is not bound to prove the value of the property subject to levy because

> [i]t would be highly inconvenient and unjust to require an innocent plaintiff to prove the value of the goods which had been in the sheriff's power but which, through his neglect, may have been eloigned beyond the reach of plaintiff's investigation. [Id.]

I conclude that plaintiff was denied the benefit of the writ and that the consequential loss amounts to the judgment debt of $6,317 less any amounts heretofore collected.

The difficult, distasteful aspects of executing writs demand that sheriffs be dealt with fairly, with an eye to the practicalities of their job. My reluctance to amerce a sheriff beset with such unpleasant tasks is only overcome by the convincing proof that Sheriff Lanzaro owed and breached a duty to plaintiff to make the successive levies as requested. In short, by invoking the remedy of amercement, I choose to satisfy plaintiff's debt where the sheriff has not.

1.7. Property Garnishments

Garnishment is similar to execution. It is a procedure to recover property belonging to the debtor that is held by a third person. The writ of garnishment is directed to the third person holding the judgment debtor's property (often a bank or an employer). The writ directs the garnishee to file a "return" identifying any property belonging to the judgment debtor in the garnishee's possession. The writ covers any property held by the garnishee and owing to the judgment debtor

from the time the writ is served until the garnishee files the "return" with the court. The judgment debtor is given a copy of the return and has an opportunity to claim exemptions or make other objections before the property is turned over by the garnishee to the levying officer. The writ thus covers not only property in the garnishee's hands on the date the writ is served, but any property coming into the garnishee's hands from the date of service until the writ is returned. The period between service and return is known as the "net."

As soon as the writ of garnishment is served on the third party holding property belonging to the judgment creditor, the creditor receives a judicial lien on the property that is subject to garnishment. If the garnishee does not comply with the writ, the garnishee is personally liable for the judgment debtor's loss. The garnishee must freeze the judgment debtor's property or accounts upon being served with the writ of garnishment, or run the risk of personal liability for failing to comply with the writ.

It is common for debt collectors to "spray" writs of garnishment on local banks in order to capture money which the judgment debtor may have in any accounts at those banks. Collection lawyers also use databases to find bank accounts in which a judgment debtor may have deposit accounts or safe deposit boxes. The power to freeze a judgment debtor's accounts provides a powerful incentive for payment, because judgment debtors are effectively frozen out of the banking system.

1.8. Wage Garnishments

Wage garnishments are similar to property garnishments but cover present and future wages owing by an employer to the judgment debtor. Because wage garnishments threaten the judgment debtor's ability to survive, there are special exemption statutes at both the state and federal level exempting from garnishment a significant portion of the judgment debtor's earnings.

There are at least two sets of laws that protect judgment debtors from wage garnishments: The Federal Wage Garnishment Law, 15 U.S.C. § 1672 et seq, reprinted in Appendix B, applies throughout the United States and provides two sets of limits: (1) a floor preventing any wage garnishment for low income workers, and (2) a maximum percentage that may be garnishment from higher income workers. 15 U.S.C. § 1673.

In computing garnishment limits, you must first determine the base pay to which the garnishment limits are applied. The federal law uses "disposable earnings" as the base. 15 U.S.C. § 1672. You must then determine the limits based on the judgment debtor's actual paycheck.

The current federal minimum wage is $7.25 per hour. The garnishment floor is this 30 times the minimum wage per week, or $217.50 of disposable earnings per week: If the judgment debtor makes less than $217.50 per week in disposable earnings, all of the judgment debtor's wages would be exempt and would not be subject to garnishment. If the judgment debtor made more than $217.50 per week, a private creditor could garnish the excess disposable earnings over $217.50 per week UP TO 25% of the judgment debtor's disposable earnings. To comply with the federal garnishment limits, an employer must make two calculations: (1) By how much did the judgment debtor's disposable earnings exceed $217.50? (2) What is 25% of the judgment debtor's disposable earnings? Whichever of these two numbers is lower is the federal garnishment limit. If

the judgment debtor gets paid bi-weekly, double the limits. If the judgment debtor gets paid monthly, multiply the limits by four.

1.8.1. State Wage Garnishment Exemptions

Many states offer more generous wage garnishment exemptions than the federal garnishment limitations. State laws cannot be less generous than the federal limits, but they can be more generous. *See* 15 U.S.C. § 1677.

Some states have no limitations on wage garnishment (allowing the 25% limit from the federal statute to govern); others allow no wage garnishment at all. Some states provide that amounts reasonably necessary for support are exempt rather than specifying limits. In these states, a judgment debtor would have to file a claim of exemption with the court to get a determination that wages above the federal limits are exempt. As of the date of publication, this website has links to the various state garnishment limitations.

In New York, for example, wage garnishment cannot exceed 10% of the judgment debtor's gross wages. Thus in New York, the employer must make three calculations: (1) the amount of judgment debtor's disposable wages over $217.50 per week, (2) 25% of the judgment debtor's weekly disposable wages, and (3) 10% of the judgment debtor's weekly gross wages. Whichever of the three numbers is LOWER is the garnishment limit in New York.

Because of the complexity of these rules, I have seen many employers in New York simply withhold 10% of the judgment debtor's gross wages without applying the federal limits, which is a clear violation of federal law.

1.8.2. Exceptions to Wage Garnishment Limits

There are several important exceptions to the federal wage garnishment limits.

First, as provided in the statute, family support claims have a much higher federal limit (50-65% of disposable earnings).

Second, the Federal Wage Garnishment Law does not apply to state or federal tax collections. The Internal Revenue Service can garnish wages after assessing unpaid taxes without suing and obtaining a judgment. The IRS can garnish all of your wages above the amount that it has determined is necessary for a person to survive, which is based on the filing status and tax exemptions claimed by the debtor on its tax return. The IRS has published a chart showing the exemption amounts.

Third, federal student loan garnishments are subject to different limits. 31 U.S.C. § 3720d, part of the Debt Collection Improvement Act of 1996, Pub. Law 104–134, 110 Stat. 1321-362 (Apr. 26, 1996) (federal student loan garnishments limited to 15% of disposable earnings). Federal student loan garnishments are also subject to the federal floor of 30 times the minimum wage. *Id*.

Fourth, the statutory limits reflect the total amount that may be garnished by all creditors. I had a case where an employer received several garnishments from different creditors, and

withheld the 10% New York limit for each creditor, taking 30% of the employee's wages. That was clearly wrong. The limits are aggregate limits designed to preserve to the debtor a living wage. If there are multiple garnishments, the first garnishee gets paid; the others have to wait to be paid in order until the prior garnishees are fully paid. *See* Department of Labor Fact Sheet 30; and the full regulations at 29 CFR Part 870.

1.8.3. Practice Problems: Calculating Wage Garnishment Limits

Calculate the maximum garnishment amount for a judgment debtor who resides in New York and earned the following amounts every two weeks:

	Gross Wages	Overtime Pay	Taxes Withheld	Voluntary Pension Contribution	Mandatory Union Dues	Payment Received
Mar 01	$ 500		$ (14)	$ (90)	$ (30)	$ 366
Mar 15	$ 500	$ 248	$ (37)	$ (90)	$ (30)	$ 591
Apr 01	$ 500	$ 20	$ (26)	$ (90)	$ (30)	$ 374
Apr 15	$ 440	$ -	$ (22)	$ (90)	$ (30)	$ 298
May 01	$ 560	$ 50	$ (31)	$ (90)	$ (50)	$ 440
May 15	$ 350		$ (18)	$ (90)	$ (60)	$ 183
Jun 01	$ 500	$ 540	$ (52)	$ (90)	$ (60)	$ 838

1.9. State Law Execution Exemptions

State laws also commonly exempt many kinds of personal property, as well as real estate used as a principal residence (homestead), from execution. State exemption statutes vary widely – some states provide an unlimited homestead exemption regardless of the value of the home, while other states only exempt a homestead up to a few thousand dollars. Household goods (clothes, furniture and the like) are usually exempt, as are cars up to a certain value. In most states, the exemption applies to the judgment debtor's equity in the property (the value of the property above other liens). A list of state exemption statutes is available at http://www.legalconsumer.com/bankruptcy/laws/. The New York exemption statute is reprinted in Appendix C.

1.9.1. Practice Problems: Enforcement of Judgments and Exemptions

A creditor has obtained a $100,000 judgment against an unmarried debtor who lives in New York. The debtor asks you whether the creditor can collect the judgment from the following assets owned by the judgment debtor. Review the New York exemption statute and answer the following questions:

Problem 1. The debtor has $10,000 in a bank account. How much can the creditor take?

Problem 2. Can the creditor take the debtor's car, worth $5,000?

Problem 3. May the creditor force the sale of the debtor's house in Syracuse (Onondaga County) worth $125,000? The house is subject to a $40,000 mortgage?

Problem 4. What if the house is worth $110,000?

Problem 5. The Debtor purchased a car for $3,000, paying $300 down, and borrowing the $2,700 balance from the car dealer. The car dealer has a security interest in the car. If the debtor stops paying, what can the car dealer do?

1.10. Other Federal and State Exemptions

There are many exemptions from execution that are not contained in the general state exemption statute, but instead are buried in other federal and state statutes. The most important exemption is for Social Security payments. Read the exemptions in the Social Security Act, 42 U.S.C. § 407, which is contained in Appendix D. After reading the Social Security exemption statute, can you understand why social security recipients should be advised to keep their social security proceeds in an account that contains only social security proceeds (and not any other form of income)?

1.11. Federal Tax Collection

The one creditor who is not subject to state and federal exemptions laws (outside of the Internal Revenue Code) is the Internal Revenue Service. The IRS does not have to go to court to obtain a judgment or levy. Instead, the IRS only needs to make an "assessment" before the process of collection can begin.

There are three basic ways that the IRS can make an assessment: (1) the taxpayer can file a return showing taxes due (this is referred to commonly as a "self-assessment"), (2) the IRS can file a substitute for return if the taxpayer does not file one (generally based on reported income and the standard deduction) and assess the taxes shown as owing, or (3) the IRS can follow statutory procedures to recover a deficiency judgment. The IRS makes the assessment by simply recording the taxpayer's obligation in its records.

As part of its collection power, the IRS can offset federal tax refunds, garnish social security benefits, and levy upon real or personal property without regard to state or non-tax federal exemption laws. The Internal Revenue Code provides "Notwithstanding any other law of the United States, no property or rights to property shall be exempt from levy other than the property specifically made exempt by subsection (a)." 26 U.S.C. 6334(c). The IRS exemptions (26 U.S.C. 6334(a)) include wearing apparel; school books; fuel and provisions, furniture, and personal effects, not to exceed $500 in value; books and tools of a trade, business, or profession, not to exceed $250 in value.

Despite its broad statutory collection power and its reputation in many quarters, the IRS tends to be a gentle creditor if the debtor communicates promptly and openly with the IRS. If a debtor ignores the IRS's tax notices, the IRS computers will proceed with the automated process of collection. On the other hand, the IRS tends to be very generous with those who call the IRS to explain their situation. The IRS will negotiate payment plans and put people who cannot afford to pay in uncollectable status. The important thing is to communicate with the IRS rather than hoping the problem will go away on its own.

1.12. State Law Avoiding Powers – Fraudulent Transfers Law

In order to prevent debtors from harming creditors by fraudulently transferring the debtor's property to others, state law gives creditors a right to avoid or set aside a transaction between the debtor and a third party that harmed (or is presumed to have harmed) the creditor. Under the fraudulent transfer laws, the debtor's creditors can sue the transferees to recover the property, or in some cases can recover the value of the property from the transferees.

There is a long history of fraudulent laws dating back to the English Statute of 13 Elizabeth (13 Eliz 1, c 5) in 1571. In modern times, the Uniform Fraudulent Conveyance Act ("UFCA") was promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws, and became the law in most states until the National Conference proposed a more modern version called the Uniform Fraudulent Transfers Act ("UFTA") in 1984. The UFTA was adopted in every state except New York (which had stubbornly clung to the old UFCA). In 2014, the National Conference adopted a new version of the law called the Uniform Voidable Transactions Act ("UVTA"), which at the time this book is written has been adopted in 22 states, including the big commercial states of New York and California. The New York version of the UVTA, which became effective in 2020, is attached in Appendix E.

It is important to note several things about the NY-UVTA. First, the Act addresses two primary kinds of transfers: (1) transfers made with **actual intent** to hinder, delay or defraud creditors (or certain kinds of knowledge that the transfer will likely result in an inability to pay creditors) (NY-UVTA § 273) and (2) transfers that are **constructively fraudulent** (without requiring a showing of fraudulent intent) because the debtor did not receive reasonably equivalent value ("REV") in return for the transfer, and was insolvent or was rendered insolvent (or something like insolvent) by the transfer (NY-UVTA § 274). The idea behind a constructive fraudulent conveyance is that an insolvent debtor is essentially giving away money or property to the transferee that should rightfully belong to the insolvent debtor's creditors.

Second, the NY-UVTA covers not only transfers of property, but also the incurrence of fraudulent obligations which would dilute the distributions to other unsecured creditors. *See* NY-UVTA § 273, 274 ("transfer made or obligation incurred").

Third, the definition of "value" in NY-UVTA § 272 is important. With an exception for transfers to insiders discussed below, payments or transfers to creditors (or transfers of security interests to unsecured creditors), in preference to other creditors, are not avoidable because they are deemed to be for "reasonably equivalent value," since "value" includes the payment or securing of an antecedent debt. *Id*. Similarly, transferring a security interest in property to an existing unsecured creditor is not avoidable because the antecedent debt is "value" in exchange for the

security interest, even though other creditors are diluted by the transfer of the security interest if the debtor is insolvent. With the one exception for transfers to insiders discussed below, these preferential transfers to creditors are not avoidable under state law.

The exception allows unsecured creditors to avoid preferential payments to **insiders** on account of an antecedent debt and made while the debtor is insolvent. NY-UVTA § 274(b). Insiders are defined in lengthy rules as relatives within the third degree of consanguinity, and affiliated entities. *See* NY-UVTA 270(h) and (n).

NY-UVTA § 276(A) is a new and rather strange addition (not contained in the official UVTA) allowing a creditor who has a statutory right to recover attorneys' fees in the underlying action to recover reasonable attorneys' fees incurred in avoiding a fraudulent transfer (notwithstanding the creditors' fee arrangement with its lawyer, or its waiver of fees in the underlying action). It is odd that the provision appears only to apply to creditors who have **statutory** rights to recover attorneys' fees, and not to creditors who have **contractual** rights to recover attorney's fees). Does this provision imply that creditors having contractual rights to attorneys' fees will not be able to recover attorneys' fees incurred in avoiding fraudulent transfers, or does the limitation only apply when seeking to recover such fees from the transferee (who was not a party to the attorney's fee clause)?

Finally, the statute of limitations requires a creditor to act promptly after the transfer is made (or in certain cases after learning of the transfer). Under NY-UVTA § 278(a), actual intent fraudulent conveyances are avoidable for 4 years after the transfer was made, but creditors are given at least one year after discovery to avoid the transfer. Under NY-UVTA § 278(b), constructive fraudulent transfers are avoidable for 4 years after the transfer was made, and discovery is irrelevant. Finally, under NY-UVTA § 278(c), insider preferences are avoidable only if the action is brought within 1 year after the transfer.

Review New York's UVTA in Appendix E and answer the following questions:

1.12.1. Practice Problems: Fraudulent Transfers

Problem 1. Debtor owes $100,000 to creditors. Debtor's assets are worth $50,000. Debtor gives her $10,000 tax refund to help her adult son so that he can rent an apartment and buy a car to get to work. Can the creditors do anything about the expenditure? Read carefully NY-UVTA § 274(a), and the definition of insolvency in NY-UVTA § 271. If instead of giving her son a tax refund, the Debtor gave her son a car worth $10,000, could unsecured creditors recover the car? NY-UVTA § 276(a)(1) and (b). Could they recover a judgment against the son for $10,000? NY-UVTA § 277(b)(1). What if the Debtor gave the son $10,000 from her social security payments that were exempt from execution? *See* NY-UVTA § 270(b)(2). Would your answer to these questions change if the value of the debtor's assets exceeded her liabilities by more than $10,000?

Problem 2. Debtor owes $100,000 to creditors, and has assets worth $50,000. Debtor's son needs an apartment. The landlord is not willing to rent the apartment to Debtor's son unless Debtor guarantees the rent. Would creditors be harmed by the guaranty? If so, what can creditors do if Debtor guaranties the rent? NY-UVTA § 274(a). Can creditors avoid the guaranty as a

fraudulent transfer even though the creditor gave value by allowing the son to occupy the apartment? *See* NY-UVTA § 277(a).

Problem 3. Debtor owes $100,000 to her father, and $50,000 to EasyBank. Debtor owns a (non-exempt) house worth $75,000. Debtor offers to give her father a lien on the house to secure the $100,000 debt. Would EasyBank be harmed by the granting of the lien? Could EasyBank avoid the granting of the lien as a fraudulent transfer? *See* NY-UVTA § 274(b). What if the lien was given to the Debtor's best friend who had lent the Debtor $100,000 on an unsecured basis six months earlier?

Problem 4. In need of fast money, Insolvent Al pawns his only valuable asset, a 1935 Martin Guitar, at a local pawn shop called PawnWorld for $500 cash. A similar guitar recently sold on eBay for $1,500. Is the pawn a fraudulent conveyance? Would Al's failure to redeem the pawn be a fraudulent conveyance? If it is a fraudulent conveyance, could unsecured creditors recover the guitar? NY-UVTA § 276. Could creditors recover a money judgment from Pawnworld? NY-UVTA § 277(b)(1). Does it matter that PawnWorld did not know that Al was insolvent? *See* NY-UVTA § 274(a). Would it make any difference if PawnWorld was required by state law to hold a public sale of pawns that were not redeemed, and bought the guitar for $500 at the sale? *See* NY-UVTA § 272(b).

Problem 5. After Al in Problem (4) failed to timely redeem the pawn, and PawnWorld became the owner of the guitar automatically under the agreement, you then purchased the guitar from PawnWorld for $1,000 knowing nothing about Al or his financial problems. Could creditors recover the guitar or its excess value from you? *See* NY-UVTA §§ 276 and 277(b)(1)(ii).

Problem 6. What if the guitar was worth $20,000 rather than $1,500, and Al's creditors came after you for $19,000 (the difference between the value and what you paid). Do you have a defense under NY-UVTA § 277(b)(1)(ii)? Is there anything the creditors could recover from you? *See* NY-UVTA §§ 276, 277(d).

1.13. The Race to the Courthouse and the Concept of Bankruptcy

An unsecured creditor is like a caterpillar with a few suasion powers to enforce payment, but no power to sell the debtor's assets to obtain money to satisfy the debt. The unsecured caterpillar cannot sell a debtor's assets and can only use legal suasion to obtain voluntary payment. Only a butterfly (a secured creditor) can cause the sale of the debtor's assets to obtain money to pay the debt.

But the unsecured caterpillar turns into a secured butterfly through the judicial lien process. Once becoming a butterfly, the former caterpillar has rights in the debtor's property that can be enforced through sale. But secured butterflies must compete with each other over the proceeds from the sale of the debtor's property. State law favors the swiftest creditors. The first unsecured creditor to obtain a judgment and cause the levying officer to levy against the debtor's property gets paid first out of the proceeds. Slow creditors may not get paid at all, as faster creditors devour the debtor's assets. This is known as the "race to the courthouse," as creditors rush to be the first to get a judgment and levy on the debtor's property.

There are two basic rules governing judgment creditor priority (which creditor gets paid first). In the majority of states, the first creditor to levy has priority over later levying creditors. In a minority of states, the first creditor to deliver a writ of execution to the levying officer has priority over later delivering creditors if the sheriff ultimately successfully levies. In either case, it is the law of the jungle, survival of the fittest, with creditors pushing to be the first to obtain their judgment, deliver it to the sheriff, and levy on the debtor's property.

The race to the courthouse makes it difficult for debtors to negotiate with creditors for additional time to pay, because those generous enough to grant additional time fall behind in the race to become a secured butterfly and have priority over later butterflies.

Historically, the process of bankruptcy was designed by creditors to avoid the race to the courthouse. Instead of creditors competing with each other and often forcing quick sales of the debtor's property for low prices, creditors join together in a bankruptcy proceeding to obtain the orderly sale of the borrower's property and distribution of the sale proceeds to all creditors proportionally. The historical process of bankruptcy was a method for collective action by creditors. Today, however, almost all cases are initiated by debtors who seek bankruptcy protection in order to obtain the benefits of a bankruptcy automatic stay and discharge. See David S. Kennedy, James E. Bailey, III & R. Spencer Clift, III, THE INVOLUNTARY BANKRUPTCY PROCESS: A STUDY OF THE RELEVANT STATUTORY AND PROCEDURAL PROVISIONS AND RELATED MATTERS, 31 UMEM L. REV. 1, 3 (2000) (In 1998 less than 1/1000 of one percent of all filings were involuntary).

There is one more part of state law that we must understand before we begin the study of bankruptcy law. The process by which the faster judgment creditor has priority over slower judgment creditors, at its core, recognizes that the faster levying creditor has a special interest in the property. This special property interest is known as a "lien," specifically a judicial lien. A lien is an interest in property to secure a debt or other obligation. In the next chapter we will look at the various kinds of liens that exist under state law, the special rights given to lienholders over unsecured creditors, and how priority between competing lien creditors is determined.

Chapter 2. Secured Claims

2.1. Liens and Priority

In Chapter 1, we looked at the process for collecting unsecured claims and noted that creditors have two basic options – (1) obtain voluntary payment from the debtor, or (2) use the judicial process for obtaining and enforcing a judgment. The judicial process is slow and expensive, and fraught with the risk that other creditors will win the race to the courthouse, and thus render the judicial effort fruitless.

There are three kinds of liens. We have already looked at judicial liens obtained when a judgment creditor causes a levy on the debtor's property. In this chapter, we will look at two other types of liens: (1) consensual liens, and (2) statutory liens.

We will also look at the **priority** between lienholders. Priority is the most important question in the process for it determines the order in which lienholders get paid from the sale of the property that is subject to the lien, which we call the "collateral." Under the absolute priority rule, creditors with higher priority get paid in full before creditors with lower priority get anything from the proceeds of sale.

The first step is the process of creating a lien, known as **attachment**. Once the lien is created, or attaches, it is enforceable between the debtor and the creditor, but it does not necessarily protect the creditor from later creditors or buyers who also obtain liens against the collateral or purchase the collateral.

The second step, known as **perfection**, is **normally** the process of giving constructive notice of the existence of the lien to the world in the hope of preserving the lienholder's priority against later lien creditors or buyers. However, some liens are perfected without giving notice. Given the number of exceptions to the general concept, it is difficult to define the concept of perfection in a coherent way. Maybe the best way to think about perfection is as the point where the lienholder has done all that the lienholder can do under the statute to obtain priority over later creditors and buyers, but it does not necessarily determine that the lienholder will have priority over later lienholders or buyers.

The final step, **priority**, is the conclusion about which secured creditors or lienholders get paid first out of the proceeds from the sale of the collateral. Priority is the key to getting paid out of the collateral.

2.2. Attachment of Consensual Liens

Consensual liens are an alternative to unsecured credit. A consensual lienholder obtains a property interest (a lien) in the debtor's collateral to secure repayment of the debt.

It is always important to remember that a lien is a property interest, but it does not entitle the lienholder to ownership of the property. The debtor retains the **right to redeem** the property from the lien by paying the debt in full (until the debtor's right of redemption is **foreclosed**).

Different documents are used to create consensual liens on real property and personal property (everything other than real property).

2.3. Attachment of Consensual Liens on Real Property

Consensual liens on **real property** are created when the debtor transfers a lien in the debtor's property to the creditor by way of a written **mortgage or deed of trust**. In some states, called "title states," the instrument transfers legal title to the property to the creditor who holds title to the property subject to an obligation to re-convey title to the debtor when the debt is paid. In other states, called "lien states," only a lien interest in the property rather than title to the property is transferred by the debtor to the creditor, and the lien is terminated upon repayment. In practice the distinction between title and lien states is one of form rather than substance, but will affect the language used in the instrument of transfer (the mortgage or deed of trust).

A mortgage is a two party instrument under which the owner of the property transfers title (subject to re-conveyance) or a lien (subject to termination) to the creditor as security for the loan or other credit. A deed of trust is a three party instrument under which title or a lien is transferred to a trustee to hold for the benefit of the creditor if the loan or other credit is not repaid. Once again, in practice the distinction between a mortgage and deed of trust is one of form rather than substance and is not very important. It is important for a lawyer (or other party) documenting a transaction to use a proper form for the jurisdiction in which the property is located.

2.4. Attachment of Consensual Liens on Personal Property

Consensual liens on **personal property** (everything other than real property) can be created with a **pledge** or with a written **security agreement**. A pledge is a physical delivery of the collateral to the creditor to hold until payment is made. A security agreement is a written document by which the debtor (or owner of the property) conveys a lien, called a **security interest**, in the property to the creditor.

Consensual liens on personal property are governed by Article 9 of the Uniform Commercial Code ("UCC"), which has been enacted as law in every state (although some states have non-standard provisions). Article 9 is one of the most uniform provisions of the UCC. It has been enacted in every state with only minor variations between states. New York's version of UCC Article 9 is reprinted in Appendix F. For your convenience, the Article 9 code sections in this book are linked – if you are reading an electronic copy of this book you may click on the links to jump to the full code sections.

There are exceptions to the application of Article 9 for special kinds of property under state or federal law, such as personal use automobiles that are registered with the motor vehicles department, and aircraft that are registered in a special federal filing office in Oklahoma City. In most states, a security interest in a personal use automobile must be noted on the vehicle's official title document to be perfected. However, vehicles held by a dealer in inventory for sale or rental are generally governed by the Article 9.

A security interest (or lien) does not **exist** under Article 9 of the UCC until the requirements for **attachment** of the lien have occurred. Attachment is a key concept under the UCC, and should not be confused with the provisional remedy of prejudgment attachment in a law suit discussed above.

The basic rules for the attachment (or creation) of a security interest are contained in UCC § 9-203, which is so important that you should commit its terms to memory. Note the three requirements in 9-203(b) that all must occur before the lien exists. The lien exists as soon as all three of those requirements occur, and the creditor (now the "secured party") may then enforce the lien against the debtor's property upon default.

A simple security agreement contains a grant by the debtor to the creditor of a security interest in the debtor's property. It must describe the collateral in sufficient detail to reasonably identify it, but it is sufficient to identify the property by items and types. UCC § 9-108(a). For example, the security agreement may cover "all inventory" or "all equipment," or may identify a particular item (i.e. Morganthaler Printing Press Serial Number 87645374-9863).

The security agreement must identify the obligations that are secured by the collateral. The language can be quite broad in covering all debts to the creditor, such as "all of the debtor's past, present and future obligations to the creditor," or it may apply to a particular obligation, such as "to secure creditor's loan in the original principal amount of $1,000,000 made on July 15, 2015."

The security agreement should provide for a lien on any **proceeds** from sale, lease or loss of the collateral, as well as anything that grows out of the collateral such as products, offspring, or rents, although a lien on proceeds is automatic for a certain period of time. *See* UCC § 9-315(a)(2).

The security agreement may contain buyer warranties regarding the maintenance and use of the collateral (i.e. "borrower will maintain the property in good order and repair, will keep property insured . . .").

The security agreement must consider whether special rules are needed for the sale of the collateral. For example, a lender who has a security interest in the inventory of a grocery store may permit the sale of the collateral in the ordinary course of the debtor's business before default, and may set up procedures for the proceeds (or some percentage of the proceeds) to be segregated in a lock box account for the creditor's benefit, or may permit the proceeds to be used only to purchase additional inventory subject to the security agreement. The security agreement should contain the terms of the "deal" between the borrower and lender regarding the collateral.

The security agreement should also specify what constitutes an "event of default," and what rights the creditor has upon default (including self-help, discussed below).

In order to be valid, the security agreement must -- in the language of the UCC -- be **authenticated**, which generally means signed by the debtor. UCC §§ 2-103(p); 9-203(b)(3)(A).

2.5. Attachment of Judicial Liens

We have already looked at the basic process for creating judicial liens in Chapter 1. A judicial lien on personal property is created, or attaches, when the sheriff levies against the debtor's non-exempt personal property under a writ of execution.

While a judicial lien on real property can be created by levy, in most states there is a less expensive procedure for creating judicial liens on real property – by filing evidence of the judgment in the county real property records. States have different names and procedures for the process of obtaining judicial liens on real property by filing. In California, an "abstract of judgment" must be recorded in the real property records. Cal. Civ. Proc. Code § 697.310. In New York, it is a "transcript of judgment" that must be docketed with the clerk of the county where the property is located. NYCPLR § 5203. Some state laws give judgment creditors an automatic lien on real property located in the entire state or located in the county where the court is located as soon as the judgment is entered, requiring buyers or creditors to search both the county real property records where the property is located, and court records where actions against the owner could be filed. In states where real property judgment liens can only be created by filing evidence of the judgment in the real property records, a single search of the county records where the property is located will be sufficient.

Judgment liens last a long time (for example 10 years in New York), and make it difficult for the borrower to sell the property or use the collateral for an additional loan without paying off the lien (because a buyer or subsequent lender would take the property subject to the lien unless it is paid). Buyers and lenders will generally require a policy of title insurance at closing to assure that title is clear. The title insurance company must do a search of the required filing offices to determine what liens exist, and the buyer will typically require that any liens be paid in full at the closing of the sale.

In addition to waiting for a voluntary sale to occur, judicial lienholders can also foreclose their liens through a judicial sale conducted in accordance with a statutory procedure.

A few states have enacted statutes permitting **judgment liens on personal property** to be created by filing evidence of the judgment with the secretary of state, rather than going through the levy process. *See* e.g. Cal. Civ. Proc. Code 697.510. These filing procedures usually prevent the judgment debtor from selling the property, or using the property that is subject to the lien as collateral for a loan, without paying off the judgment.

One big difference between the filing process and the levying process to obtain a judgment lien is that the creditor does not have to identify the specific property when filing. When evidence of the judgment is filed in the county real property records (or with the secretary of state in those states that permit judicial liens by filing on personal property), the lien automatically attaches to all real property owned by the judgment debtor in the county (or all non-exempt personal property owned by the judgment debtor in the state). Furthermore, a lien will attach to any real property acquired by the judgment debtor in the county (or non-exempt personal property acquired by the judgment debtor in the state) after the filing. The filing office will index the judgment **by the name of the judgment debtor**, allowing later buyers or creditors to perform a search on the judgment debtor's name to determine the state of title to the judgment debtor's property.

2.6. Attachment of Statutory Liens

Statutory liens are, as you may surmise, created by statute for certain favored creditors. The best known statutory lien is the mechanics' lien, typically given to a contractor who improves the debtor's real property or automobile. There are many other kinds of statutory liens for creditors

like laborers, farmers who sell food, milk producers and many others. Governments also give themselves special statutory liens for things like property taxes and withholding taxes. These liens often require the creditor to follow strict procedures in order to obtain lien rights, such as filing a notice in the real property records within a specific period after commencing work under the contract, and filing suit within a specific period if payment is not forthcoming. Other statutory liens arise automatically and require buyers or consensual lien creditors to obtain releases from potential statutory lienholders.

2.7. The Concept of Perfecting Liens

Perfection is usually the process by which a lienholder gives constructive notice to the world that the lienholder has a lien on the collateral. Through the process of perfection, later buyers or lienholders are given constructive notice of the existence of a particular lien, and will either take an interest in property subject to (or subordinate to) that lien, or will require the lien to be satisfied before new credit is given. Perfection generally requires a creditor to follow some statutory act that will put later parties who wish to obtain an interest in the property on notice that the creditor holds a lien. The act may be the creditor taking possession of the property in a pledge, or filing notice of the lien in a designated filing office. However, some liens against certain kinds of property are automatically perfected upon attachment, requiring no action on the part of the creditor to perfect, and no obvious way for later parties to know of the existence of the lien. In these situations, later parties bear the risk of a secret perfected security interest, making the property difficult to use as collateral for a loan or to sell. In most cases, however, there is a process that must be followed to perfect a security interest, and if followed later parties will be able to determine that the lien exists before extending credit to the debtor on the basis of the collateral.

2.7.1. Perfection of Consensual Personal Property Liens

Article 9 of the UCC contains the rules governing the priority of personal property liens between secured creditors. Article 9 of the UCC contains rules that also address the relative priority of judicial liens and consensual liens. We will focus first on the general Article 9 rules addressing the perfection and priority of consensual liens on personal property, and then on the relative priority of those consensual liens against judicial liens on the same property.

Statutory liens must have their own rules of priority because they are not addressed in Article 9. Some statutory liens (like real property liens) become a first charge against the property having priority over even earlier consensual or judicial liens. Other statutory liens like most mechanic's liens date from the commencement of services or the sale of property. A lawyer must look to the specific state law statute under which the statutory lien was created to determine the priority accorded to the lien.

We have previously looked at the three requirements for a security interest to **attach** - the point at which the lien or security interest **exists** and is enforceable by the creditor against the debtor's property. UCC § 9-203.

Most security interests in personal property are **perfected** by the filing of a **UCC-1 financing statement** with the office of the Secretary of State where the debtor resides. UCC § 9-301(1), 9-307(b) (residence for individuals, chief executive office for unregistered entities, and state of incorporation for registered entities, Washington DC for foreigners). The UCC-1 financing statement is a simple one-page form that lists the name and address of the debtor, the name and address of the creditor, and a general description of the collateral. A UCC-1 financing statement form is printed in Appendix I.

Many security interests can also be perfected by the secured creditor taking physical possession of the collateral (this is known as a "pledge"). Indeed, certain kinds of collateral (money and negotiable instruments, for example) can only be perfected by the secured creditor taking possession or control over the collateral. The theory is that the debtor's inability to produce the physical property gives notice to the world that the debtor does not hold free unencumbered title to the property. A potential creditor or acquirer who expects to have priority in the collateral needs to be sure (1) that the debtor has possession of the collateral, (2) that the debtor has legal title to the collateral, and (3) that no UCC-1 financing statements have been filed with the Secretary of State by other creditors.

However, even these steps are not fool proof, because some security interests are automatically perfected upon attachment without filing or pledge; most notably purchase money security interests in **consumer goods**. UCC § 9-309(1). An understanding of these general rules is important for this course; therefore the general rules are reprinted below.

Uniform Commercial Code

> § 9-302. WHEN FILING IS REQUIRED TO PERFECT SECURITY INTEREST; SECURITY INTERESTS TO WHICH FILING PROVISIONS OF THIS ARTICLE DO NOT APPLY.
>
> A financing statement must be filed to perfect all security interests except the following: [exceptions omitted]
>
> § 9-303. WHEN SECURITY INTEREST IS PERFECTED; CONTINUITY OF PERFECTION**.**
>
> (1) A security interest is **perfected when it has attached and** when **all of the applicable steps** required for perfection **have been taken**. Such steps are specified in Sections 9-302, 9-304, 9-305 and 9-306. **If such steps are taken before the security interest attaches, it is perfected at the time when it attaches**.
>
> § 9-309. SECURITY INTEREST PERFECTED UPON ATTACHMENT.
>
> The following security interests are perfected when they attach:
>
> > (1) a purchase-money security interest in consumer goods, except as otherwise provided in Section 9-311(b) with respect to consumer goods that are subject to a statute or treaty described in Section 9-311(a).
> >
> > [Balance omitted; emphasis added].

2.7.2. Priority of Consensual Liens on Personal Property

As a practical matter, priority is the most important stage in the process. Priority tests a secured creditor's right to be paid first out of the collateral against the rights of other secured creditors. Under the absolute priority rule that applies both in and out of bankruptcy, senior priority secured creditors must be paid **in full** from the collateral before junior secured creditors receive any distribution. Attaching and perfecting a security interest puts the secured creditor in the race, but it is the creditor that has priority who wins the race and gets paid first.

Article 9 contains separate provisions dealing with the priority of conflicting (multiple) consensual security interests, and consensual security interests vis a vis judicial liens. Following are the main priority rules of Article 9. There are a number of specialized exceptions to these general rules. A bit later we will cover one of the exceptions, for purchase money security interests. But there are other exceptions that must be carefully considered in actual practice. You must refer to the whole of Article 9, covered in more detail in a course in commercial or secured transactions, to learn the full gamut of specialized Article 9 rules.

Uniform Commercial Code

§ 9-317. INTERESTS THAT TAKE PRIORITY OVER OR TAKE FREE OF UNPERFECTED SECURITY INTEREST.

(a) **Conflicting security interests and rights of** lien **creditors**. An unperfected security interest . . . is subordinate to the rights of:

(1) a person entitled to priority under Section 9-322; and

(2) except as otherwise provided in subsection (e), a person that **becomes a lien creditor before** the earlier of the time

(a) the security interest . . . is **perfected or**

(b) one of the conditions specified in Section 9-203(b)(3) is met **[authenticated security agreement] and** a financing statement covering the collateral is filed.

§ 9-322. PRIORITIES AMONG CONFLICTING SECURITY INTERESTS . . . ON SAME COLLATERAL.

(a) General priority rules. Except as otherwise provided in this section, priority among conflicting security interests . . . in the same collateral is determined according to the following rules:

(1) Conflicting perfected security interests . . . rank according to priority in time of **filing or perfection**. Priority dates from the **earlier of the time a filing** covering the collateral is first made **or** the security interest . . . is first **perfected**, if there is no period thereafter when there is neither filing nor perfection.

(2) A **perfected** security interest . . . has priority over a conflicting u**nperfected** security interest or agricultural lien.

(3) The first security interest . . . to attach or become effective has priority if conflicting security interests . . . are unperfected.

[Emphasis added]

2.8. Practice Problems: UCC Article 9

Problem 1. For each party, explain (1) when does the security interest **attach**, (2) when is the security interest **perfected,** and (3) which party has **priority** (and thus gets how much money):

A. On January 1, Year 1, Bob Drain, a licensed plumber, borrowed $20,000 from his uncle, Ed Drain, to purchase a new machine for his business. Bob signed a promissory note at the time the loan was made agreeing to repay the loan on January 1, Year 3.

B. On January 1, Year 2, Bob went to Flushing Bank to borrow $100,000 for business operating expenses. He signed a security agreement under which Bob granted Flushing Bank a security interest in all of his business property to secure any and all outstanding loans from Flushing Bank. Flushing Bank filed a UCC-1 financing statement with the Secretary of State. However, on January 3, Bob decided not to go through with the Flushing Bank loan. Flushing Bank tore up the promissory note, but left the security agreement in its files. Flushing did not terminate the UCC-1 financing statement it had filed with the Secretary of State.

C. On July 1, Year 2, Bob went to Prime Bank to borrow $100,000 for his business. Prime performed a secretary of state database search, which disclosed the Flushing UCC-1 financing statement. Bob told Prime Bank that he had not gone through with the Flushing Bank loan. Prime Bank called Flushing Bank and confirmed that the Flushing Bank loan had not been made, and that Bob did not owe Flushing Bank any money. Prime therefore agreed to make the loan to Bob. Bob signed a promissory note and security agreement with Prime Bank covering all of his business property on July 1, Year 2. Prime Bank filed a financing statement with the Secretary of State on July 4, Year 2, and gave Bob the $100,000 on July 8, Year 2.

D. On September 1, Year 2, Bob went back to Flushing Bank to borrow an additional $20,000. Flushing had Bob sign a new promissory note, and then gave him the $20,000.

E. Because of continuing cash flow problems in his business, Bob was unable to repay Uncle Ed on January 1, Year 3. Uncle Ed obtained a default judgment against Bob on February 1, Year 3, and had the Sheriff levy under a writ of execution on Bob's business assets on March 1, Year 3.

F. Bob's business assets have been liquidated for $70,000 by the Sheriff. Uncle Ed, Prime Bank and Flushing Bank all claim that they should get the money. Who gets the money?

Problem 2. Would the result change if the Uncle Ed loan was due on May 1, Year 2, Uncle Ed got his default judgment against Bob on June 1, Year 2, and had the sheriff levy against Bob's business property on July 7, Year 2?

Problem 3. Same facts as problem 2, except Uncle Ed caused the Sheriff to levy against Bob's business property on June 3, Year 2.

2.9. Purchase Money Security Interests

Purchase money security interests (also known as "enabling loans") are created in one of two ways. First, a seller of goods can agree to accept payments for the goods in the future (carry back a loan to finance the purchase), and secure the buyer's obligation to make payments with a security interest in the property sold. Second, a lender's loan proceeds can be traced directly into the purchase of the goods in which the lender takes a security interest. UCC § 9-103(a)(2). In both cases, the lender's actual or constructive loan proceeds were used to enable the purchase of the property. It is essential that the lender be able to **trace the loan proceeds directly into the purchase** – if the funds are first commingled in the debtor's bank account, it will be difficult to establish purchase money status. Therefore, purchase money lenders often issue loan proceeds checks in the joint names of the borrower and seller of the goods, or directly remit the loan proceeds to the seller – thereby assuring that the actual loan proceeds are used to purchase the collateral.

Purchase money loans are given special status in Article 9. Read UCC § 9-317 and UCC § 9-324 carefully, and answer the problems that follow.

2.10. Practice Problems: Purchase Money Security Interests

Problem 1. A corporate debtor operates a printing business. It owes $1 million to BusinessBank, secured by a perfected first priority security interest in all of the debtor's equipment, currently worth in liquidation about $700,000. The debtor believes it could make a lot more money if it could get into the new digital publishing field. In order to get into digital publishing, the Debtor needs $100,000 worth of new equipment. BusinessBank is having its own financial problems, and is not willing to lend any more money to the debtor. BankTwo, however, is willing to lend the debtor the additional $100,000 it needs, but only if it can have a first priority security interest in the new digital publishing equipment. Can you assure BankTwo that if it makes the $100,000 loan to the debtor to acquire the new equipment its security interest on the new equipment will have priority over Business Bank's existing security interest in all of the debtor's equipment?

Problem 2. Assume the same facts in problem 1, except that the debtor is a retail store, Business Bank has a security interest in the debtor's inventory rather than equipment, and the debtor wants to buy some specialized new inventory for $100,000. What would you have to do to assure BankTwo that its new $100,000 loan would be secured by a first priority security interest in the new inventory ahead of Business Bank's existing security interest in the inventory?

2.11. Perfection and Priority of Real Property Liens

While the three types of liens - judicial, consensual, and statutory, all provide a creditor with special accelerated rights of collection from the collateral over the unsecured creditors, the main advantage of lien rights is in preserving priority over other secured creditors. A commercial lawyer must have a firm grasp of the rules governing the priority of liens in order to protect clients who are about to engage in commercial transactions, and in order to be able to enforce the client's lien rights after default.

Real property liens are perfected by recording evidence of the lien in the real estate records office for the county in which the property is located.

The priority of real property liens is determined by recording acts in the 50 states. There are three kinds of priority rules in the recording acts in the United States: **race** statutes, **notice** statutes, and the majority **race-notice** statutes. Race statutes are the easiest to understand – whoever records first (either a mortgage, judgment lien, or deed) wins the priority race.

While the first to record rule of race statutes is the easiest to understand and implement, many states deem it unfair to give priority to a recorder who knew about a prior unrecorded interest. The notice and race-notice statutes attempt to address this unfairness.

A pure notice system minimizes the effect of recording by giving priority to later takers who did not have notice of prior interests. Under a pure notice system, recording only gives constructive notice to later purchasers of the prior lien. Prior interests retain priority over later takers who were aware (actually or constructively) of the prior interests. A later taker is always subordinate to a prior recorded interest because the taker will have constructive notice of the interest.

A race-notice system is similar to a notice system but focuses on the time of **recording** rather than the time of taking the instrument. The first to record has priority unless the first to record had actual knowledge of a prior interest at the time of recording. Under all three systems, the first to record without any notice of the prior interest always wins.

There is a third kind of notice besides actual and constructive notice that is much less verifiable, known as "inquiry notice." Inquiry notice arises when a buyer or lender through an inspection of the property would be on notice to inquire regarding the interest of a third person. Unrecorded buyers or tenants who are in possession of property are often protected by the concept of inquiry notice.

The recording systems work off of the **debtor's name**, not off of the location of the property (except for determining which recording office to use which is based on the county in which the property is located). Recorded documents are indexed under the debtor's name. A chain of title is established by tracing conveyances (deeds, mortgages) from the original owner of the property. Recorded documents that are not indexed by an owner are "out of the chain of title" and do not constitute a lien against the property until the indexed party becomes a record owner. One cannot determine title to or liens against property without performing a title search tracking the chain of title back to the original governmental grant.

In many states, large title insurance companies have set up "title plants" under which all documents recorded in the official records in each county are scanned and indexed by the insurance

company to make title searches quicker. The system also encourages lenders and buyers to obtain title insurance to protect against search errors or discrepancies. In states without title plants, an abstractor will be required to rummage through the county recording office to develop an abstract of title. The county recorder does not determine who is the owner of property or whether liens are valid – all the recorder does is record and index the documents as filed. The only way to settle ownership of real property (other than through title insurance) is through a judicial action to quiet title.

A few states have experimented with the Torrens System under which ownership and liens are tracked by property much like an automobile title, rather than through title searches. The Torrens experiments have been attacked by the title insurance lobby and have been rejected in most states, although a few states continue to utilize a Torrens System in certain circumstances.

2.12. Practice Problems: Real Estate Priority

Problem 1. Determine who would have priority under a race statute, a notice statute, and a race-notice statute, if the following transactions occurred on the dates indicated:

Jan 1, Year 1:	A delivers Blackacre deed to B
Jan 10, Year 1:	A delivers Blackacre deed to C
Jan 15, Year 1:	C records Blackacre deed
Jan 20, Year 1:	B records Blackacre deed

Problem 2. Determine who would have priority under a race statute, a notice statute, and a race-notice statute if the following transactions occurred on the dates indicated:

Jan 1, Year 1:	A delivers Blackacre deed to B
Jan 10, Year 1:	A delivers Blackacre deed to C
Feb 1, Year 1:	B records Blackacre deed
Mar 1, Year 1:	C records Blackacre deed

Problem 3. Determine who would have priority under a race statute, a notice statute, and a race-notice statute if the following transactions occurred on the dates indicated: Assume that C did not know about B's deed on Feb 1, but did know about B's deed before Mar 1.

Jan 1, Year 1:	A delivers Blackacre deed to B
Jan 10, Year 1:	B records Blackacre deed
Feb 1, Year 1:	A delivers Blackacre deed to C
Mar 1, Year 1:	C records Blackacre deed

2.13. Foreclosing the Right of Redemption

As discussed earlier, a lienholder does not have legal ownership to the collateral because the lienholder must re-convey or terminate the lien if the debtor redeems the debt by satisfying the

obligation in full. The debtor's right to recover the property upon full payment of the debt is known as the **equitable right of redemption**. Historically the right of redemption was recognized and protected by courts of equity, and thus the value of the property in excess of the cost of redemption became known as the "equity of redemption," or simply as "**equity**." In common language, "equity" is the excess value of the property over all of the liens and encumbrances against the property – it is the amount that the debtor would receive if the property were to be sold and the liens paid off. Attempts by creditors to "clog" the equitable right of redemption by private agreement (such as by providing that title will vest in the creditor upon default) have been rejected by courts of equity for hundreds of years.

Foreclosure is the process of terminating the debtor's equitable right of redemption. Judicial foreclosure of the right of redemption is available in all states and for all types of liens. Many states have statutory rules governing the judicial foreclosure procedure. Judicial foreclosure can be a long and expensive process if opposed by the debtor, even when the debtor does not have legitimate defenses. The judicial foreclosure process requires a lawsuit, proof by summary judgment or trial of entitlement to foreclose, followed by a judicially supervised auction sale of the property. The sale terminates all liens and interests junior to the lien being foreclosed, including the debtor's equity of redemption. In most states, the debtor can redeem the property from the lien at any time prior to the drop of the hammer at the auction sale. In some states (such as New York), judicial foreclosure is the only method available for foreclosing the borrower's equity of redemption on real property.

Some states have statutory procedures for non-judicially foreclosing the equity of redemption on real property. These procedures generally require the foreclosing creditor to provide certain statutory notices of sale to the borrower and junior lienholders, and to advertise and hold a public auction for the sale of the property. Following a properly conducted non-judicial sale in accordance with the statutory procedures, the rights of junior lienholders and owners to redeem the property are foreclosed.

Senior liens are generally not terminated by a **junior lienholder's foreclosure**. The junior lienholder is selling the state of title as of the recording of the junior lien, thus foreclosing all interests junior to the junior lien. Senior liens and interests survive the foreclosure, allowing the senior lienholder to later foreclose the redemption rights of the buyer at the junior lienholder's foreclosure sale if buyer does not redeem the senior lien.

Personal property foreclosure is governed by Article 9 of the Uniform Commercial Code, which authorizes both judicial (UCC § 9-601(a)(1)) and non-judicial methods of foreclosure (UCC § 9-610(a)). Generally, the secured creditor must first obtain possession of the collateral, and then hold a "commercially reasonable" sale of the property. Possession can be obtained judicially under expedited procedures allowed under state law. These expedited procedures have different names in different states. In New York, for example, the procedure is called "replevin," while in California it is called "claim and delivery."

The creditor may also repossess the collateral non-judicially using self-help. The primary restriction on self-help is that the creditor or its agent must proceed "**without breach of the peace**." UCC § 9-609(b)(2). The repossessor must discontinue the repossession whenever there is a risk of breaching the peace. After discontinuing the repossession to prevent a breach of the peace, the repossessor may always come back another day and try again to repossess.

The UCC does not define a breach of the peace, leaving the question for the courts. There is great inconsistency in the reported decisions. May the repossessor use trickery? May the repossessor break a chain or lock to enter premises for repossession (if permitted to do so in the security agreement)? May the repossessor pick a lock? The cases that follow give a small taste of the wide variety in reported decisions.

Judicially authorized repossession by a court officer is not subject to the "breach of the peace" restriction. UCC § 9-609(b)(1). As we saw in *Vitale v. Hotel California*, a sheriff under a court issued writ must use whatever reasonable force is necessary to execute the writ.

After the secured creditor recovers possession of the collateral, the secured creditor may complete the foreclosure process by selling the collateral in a "commercially reasonable manner." UCC § 9-610(b). Again, what is "commercially reasonable" is not defined in the UCC, and the reported cases on the margin often depend on the length of the chancellor's foot.

In most situations, the creditor must give the debtor notice of the time and place of sale so that the debtor can appear and bid to protect the debtor's interest. Read UCC §§ 9-611 and 9-612. A waiver of the right to notice is only effective if executed **after** default. UCC § 9-624.

If the creditor does everything properly, the creditor may recover a deficiency judgment from the court to the extent that the sale proceeds are less than the outstanding debt. Read UCC § 9-615. Similarly, the creditor must account to the debtor for any surplus. *Id.* The difficulty comes in when the creditor does not do everything properly. Read UCC §§ 9-625 and 9-626 carefully, and consider the ramifications of the creditor failing to follow the requirements, especially the deafening silence in the case of consumer debtors.

2.14. Cases on Enforcement of Liens

2.14.1. CHAPA v. TRACIERS & ASSOCIATES, 267 S.W.3d 386 (Ct. App. Tex. 2008)

In this appeal, we must determine whether appellants, the parents of two young children, have legally cognizable claims for mental anguish allegedly sustained when a repossession agent towed their vehicle out of sight before he realized their children were inside.

Ford Motor Credit Corp. ("FMCC") hired Traciers & Associates ("Traciers") to repossess a white 2002 Ford Expedition owned by Marissa Chapa, who was in default on the associated promissory note. Traciers assigned the job to its field manager, Paul Chambers, and gave him an address where the vehicle could be found.

On the night of February 6, 2003, unseen by Chambers, Maria Chapa left the house and helped her two sons, ages ten and six, into the Expedition for the trip to school. Her mother-in-law's vehicle was parked behind her, so Maria backed her mother-in-law's vehicle into the street, then backed her Expedition out of the driveway and parked on the street. She left the keys to her truck in the ignition with the motor running while she parked her mother-in-law's car back in the driveway and reentered the house to return her mother-in-law's keys.

After Chambers saw Maria park the Expedition on the street and return to the house, it took him only thirty seconds to back his tow truck to the Expedition, hook it to his truck, and drive away. Chambers did not leave his own vehicle to perform this operation, and it is undisputed that he did not know the Chapa children were inside. When Maria emerged from the house, the Expedition, with her children, was gone. Maria began screaming, telephoned 911, and called her husband at work to tell him the children were gone.

Meanwhile, on an adjacent street, Chambers noticed that the Expedition's wheels were turning, indicating to him that the vehicle's engine was running. He stopped the tow truck and heard a sound from the Expedition. Looking inside, he discovered the two Chapa children. After he persuaded one of the boys to unlock the vehicle, Chambers drove the Expedition back to the Chapas' house. He returned the keys to Maria, who was outside her house, crying. By the time emergency personnel and Carlos Chapa arrived, the children were back home and Chambers had left the scene.

Maria testified that the incident caused her to have an anxiety attack, including chest pain and numbness in her arm. She states she has continued to experience panic attacks and has been diagnosed with an anxiety disorder. In addition, both Carlos and Maria have been diagnosed with post-traumatic stress disorder.

Acting individually and on behalf of their children, Carlos and Maria Chapa sued Traciers, Chambers, and FMCC. Appellees settled the children's claims but contested the individual claims of Carlos and Maria.

The Chapas contend that they have legally cognizable causes of action against Traciers and FMCC for the physical and psychological injuries they sustained as a result of the appellees' breach of the duties imposed by section 9.609 of the Texas Business and Commerce Code.

The Chapas first argue that the trial court erred in granting summary judgment against them on their claim that appellees are liable under section 9.609 of the Business and Commerce Code. The Chapas correctly point out that this statute imposes a duty on secured creditors to take precautions for public safety when repossessing property. Thus, the creditor who elects to pursue nonjudical repossession assumes the risk that a breach of the peace might occur. A secured creditor "remains liable for breaches of the peace committed by its independent contractor."

The Chapas assert that FMCC and Traciers, who employed Chambers as a repossession agent, are liable for any physical or mental injuries sustained by Carlos and Maria as a result of Chambers's breach of the peace. But this argument presupposes that a breach of peace occurred. Although the material facts regarding Chambers's conduct are not in dispute, appellees deny that his conduct constituted a breach of the peace. Without further explanation, the Chapas assert that "[t]he act of taking children from the possession of their mother which leaves her in a hysterical crying state, is clearly a breach of peace."

Whether a specific act constitutes a breach of the peace depends on the surrounding facts and circumstances in the particular case. [H]ere the parties do not assert that Chambers behaved violently or threatened physical injury to anyone. Further, it is undisputed that Chambers did not know the children were in the vehicle when he moved it; thus, his actions cannot be appropriately characterized as "contrary to ordinary human conduct." When Chambers learned of the children's presence, he immediately ceased any attempt to repossess the vehicle and instead drove the children home. He did not communicate by word or gesture with Carlos or Maria Chapa before or

during the attempted repossession. On these facts, we cannot say that Chambers's conduct constitutes a "breach of the peace" as that phrase ordinarily is used in criminal or common law.

The Chapas also rely on cases from other jurisdictions specifically addressing breaches of the peace as described in the Uniform Commercial Code concerning repossession of property. They cite *Robinson v. Citicorp National Services, Inc*., a Missouri case in which Clarence Robinson defaulted on his automobile payments. 921 S.W.2d 52, 53 (Mo.Ct.App.1996). Agents of the financing company's assignee attempted to repossess the car from property owned by Marie Robinson. *Id*. Marie's husband, Odell Robinson, Sr., "told [a repossession agent] to get off the property numerous times to no avail. The alleged trespass and breach of peace ensued, and Odell suffered a heart attack and died." Here, however, Chambers removed the vehicle without confrontation and without trespassing on the Chapas' premises.

The Chapas also point to Nixon v. Halpin, 620 So.2d 796 (Fla.Dist.Ct.App.1993). In that case, Halpin, a repossession agent, was seen by the vehicle's owner and mistaken for a car thief. The car's owner summoned his office mate, Nixon, and the two men attempted to detain Halpin. While driving away, Halpin struck Nixon. The *Nixon* court concluded that the creditor "had not already peaceably removed the vehicle when the owner objected, it's [sic] continuation with the attempt at repossession was no longer `peaceable and without a breach of the peace.'" *Id*. In this case, however, the repossession agent had "already peaceably removed the vehicle" and did not continue to attempt repossession after he learned of the Chapa children's presence. Thus, the reasoning in *Nixon* supports the conclusion that Chambers did not breach the peace.

Most frequently, the expression "breach of the peace" as used in the Uniform Commercial Code "connotes conduct that incites or is likely to incite immediate public turbulence, or that leads to or is likely to lead to an immediate loss of public order and tranquility." In addition, "[b]reach of the peace... refers to conduct at or near and/or incident to seizure of property." Here, there is no evidence that Chambers proceeded with the attempted repossession over an objection communicated to him at, near, or incident to the seizure of the property. To the contrary, Chambers immediately "desisted" repossession efforts and peaceably returned the vehicle and the children when he learned of their presence. Moreover, Chambers actively avoided confrontation. By removing an apparently unoccupied vehicle from a public street when the driver was not present, he reduced the likelihood of violence or other public disturbance.

In sum, the Chapas have not identified and we have not found any case in which the repossession of a vehicle from a public street, without objection or confrontation, has been held to constitute a breach of the peace.

2.14.2. JORDAN v. CITIZENS & SOUTHERN NAT'L BANK OF SOUTH CAROLINA, 278 S.C. 449 (1982)

[Appellants] Larry and Kathy Jordan [bring this action] to recover actual and punitive damages from the Respondents for having repossessed a 1978 Ford pick-up truck in what is alleged to be a wrongful manner.

The Appellants financed the truck and failed to make at least two monthly installment payments. On September 29, 1978, at about 11:00 p.m., a Midland Recovery employee, at the

behest of the bank, found the truck with keys in it at the Appellants' residence. The employee started the motor and drove it from the driveway into the public streets. They heard the motor running but did not see the truck until it was proceeding down the street. Thinking their truck had been stolen, they pursued it in another vehicle. The pursuit lasted some thirty minutes over a distance of several miles beginning at Lexington and ending in Columbia. There is evidence from the Appellants' depositions that the driver of the truck exceeded the speed limit, failed to observe traffic signals and drove recklessly. After they were unable to apprehend the driver of the truck, they reported it as a stolen vehicle to the police and later learned that the truck had been repossessed by the bank.

In oral argument, counsel for the Appellants conceded that under the mortgage contract, and the law of this state, the repossession was proper unless it was accompanied by a breach of the peace. It is admitted that the taking of the truck from the premises of the Appellants did not amount to a breach of the peace but it is argued that the conduct of the driver of the truck in speeding, failing to observe traffic signals and in driving recklessly some distance from the residence constituted a breach of the peace and, accordingly, made the repossession actionable.

We are not at all sure that the alleged violations of the traffic laws amounted to a breach of the peace, but even if it be assumed that they did, the conduct was not incident to seizing the truck at the residence of the Appellants. The breach of the peace as contemplated by the statute and our cases refers to conduct at or near and/or incident to the seizure of the property.

We, therefore, hold the lower court properly granted the Motion for Summary Judgment and its Order is, accordingly,

Affirmed.

2.14.3. CHERNO v. BANK OF BABYLON, 54 Misc.2d 277 (NY 1967)

[T]he security agreement . . . gave the bank the right in the event of default "(a) to declare the Note and all Obligations due and payable * * * without notice or demand; (b) to enter the * * * premises * * * where any of the Collateral may be located and take and carry away the same * * * with or without legal process." The undisputed facts are that the assignor was in default under the security agreement . . . and an order made on May 31, 1966 by the Supreme Court, Suffolk County, authorizing the assignee, upon filing bond and after notice to creditors, to sell the assignor's physical assets, . . . that on June 2, 1966 . . . one of the auctioneer's employees let the bank's senior vice-president into the premises so that he could view the assets in question, that on June 3, 1966 the bank's employees entered the premises of the assignor at the direction of the senior vice-president and removed the assets in question, that admittance of the bank's employees to the premises was obtained by means of a key which was not received from anyone of the assignor's firm, the assignee, auctioneer or landlord, but was obtained from a representative of a locksmith, and that the assets seized by the bank were thereafter sold by the bank.

The contention that, assuming the validity of the security agreement, the action of the bank's employees nevertheless constituted a conversion is predicated on the propositions that . . . (2) the unauthorized entry by the bank's employees constituted a breach of the peace. Neither contention withstands analysis.

But, argues the assignee, under the default provisions of the security agreement, rights and remedies are given to the bank only "to the extent permitted by applicable law" and section 9-503 of the Uniform Commercial Code provides that "In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace." The unauthorized entry by the bank's employees, it is said, was a breach of the peace and their taking of possession, therefore, a conversion.

The short answer to it is that there was no breach of the peace. The uniform code "makes no attempt to articulate the standards for determining whether the repossession can be accomplished without breach of the peace" The phrase was, however, part of the Uniform Conditional Sales Act (and other uniform laws) in similar context, and was construed according to the common law. The classic definition of breach of the peace is "a disturbance of public order by an act of violence, or by an act likely to produce violence, or which, by causing consternation and alarm, disturbs the peace and quiet of the community" Thus, when in the course of repossession, the conditional vendee received a black eye, it was a question for the jury whether a breach of the peace had occurred, and when padlocks on a building are broken there is such force and violence as to constitute a violation of section 2034 of the Penal Law and, presumably, a breach of the peace. Here, however, the bank's employees entered by use of a key, unauthorizedly obtained. Such an entry, the assignor's consent aside, would constitute a breaking, but it is at least questionable whether in view of the consent to entry set forth in the security agreement (and to which the assignee took subject) the acts of the bank's employees could be held to be a breaking. But, breaking or not, there was nothing in what they did that disturbed public order by any act of violence, caused consternation or alarm, or disturbed the peace and quiet of the community. Nor was the use of a key to open the door an act likely to produce violence; indeed, it produced from the landlord only (1) a call for the police and (2) a request to the bank employees that they leave the key when they were through. Under the circumstances that existed during the times the bank's employees entered the premises, there was as a matter of law no breach of the peace.

2.14.4. BIG THREE MOTORS, INC., v. RUTHERFORD, 432 So.2d 483 (Ala. 1983)

A car dealership repossessed an automobile in the possession of one plaintiff, Christine Rutherford, and owned by a second plaintiff, her common law husband, C.W. Rutherford.

On this appeal, this Court is asked to decide these questions: whether the car dealer had a legal right to use self-help in the repossession of the automobile; whether the car dealer repossessed the automobile in a reasonable manner without a breach of the peace. . . .

The pertinent facts of this case are as follows: Appellees are Christine Rutherford and her common law husband, C.W. Rutherford. C.W. Rutherford purchased a 1974 Cadillac from the defendant/appellant Big Three Motors, Inc. A second defendant/appellant, Fred E. Roan, Jr., worked for Big Three Motors and was involved with the repossession of the automobile, which is the subject of this controversy.

The evidence was conflicting regarding the event surrounding Big Three Motors' repossession of Rutherford's automobile. The Rutherfords asserted that Big Three Motors breached

the peace when it repossessed the car; on the other hand, Big Three Motors and Roan claim that everything which Roan and other employees of Big Three Motors did was legally justified.

While the evidence was conflicting, the tendencies of the evidence indicate that while Christine was driving the Cadillac automobile on Interstate 65 in Mobile County, Roan and another Big Three Motors employee forced her to pull her car off the road. Roan and Christine exchanged words while they were standing on the shoulder of the Interstate. They do not agree on the exact words exchanged; therefore, they disagree on whether Roan's conduct at this time constituted a breach of the peace.

The Rutherfords presented evidence that Roan used the truck he was driving to block Christine's direct access back onto the Interstate. Roan denied this, but both parties agree that at some point in time, Roan got into the Cadillac and rode with Christine to the Big Three Motors dealership. After arriving at the dealership, Christine locked the car, took the keys with her, and went into an office of Big Three Motors. The parties disagree about the details of what took place in the office, but it is clear that at one point Christine spoke with C.W. Rutherford by telephone and told him about the events which transpired on the Interstate. Christine finally left the office and discovered that someone had then taken the Cadillac automobile from the spot where she had parked it. An employee of Big Three Motors informed her that the car had been put "in storage" because C.W. Rutherford owed payments. The parties disagree whether Big Three Motors offered Christine transportation away from the dealership. She finally left Big Three Motors in a taxicab.

C.W. Rutherford, the owner of the automobile, sued Big Three Motors and claimed . . . (3) wrongful repossession of the automobile. Mrs. Rutherford also sued Big Three Motors and in addition, sued Fred E. Roan, Jr. and Cadillac Discount Corporation. The jury returned a verdict in favor of Christine Rutherford for $15,000 and in favor of C.W. Rutherford for $10,000. Big Three Motors appealed.

On appeal, Big Three Motors claims that it legally repossessed Rutherford's automobile under the terms of their contract because Rutherford had defaulted in his payments, and because he had failed to maintain insurance coverage on the Cadillac. In Alabama "... a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace...." Code 1975 § 7-9-503 (1975). This section does not permit repossession through fraud, trickery, artifice or stealth, nor may the creditor "use force or threats of violence against the person having possession."

Rutherford does not deny that he was behind in his payments, but he contends that he had reached an agreement with one Tom Walley, the assistant credit manager of Big Three Motors. Several days prior to the time of the repossession, Rutherford claims Walley told him he could have a few extra days to make his payments without the automobile's being repossessed. Big Three Motors contends that any agreement between Walley and Rutherford, if made, would modify the written agreement between them, and a clause in the contract prohibited any modification of the contract. Rutherford does not dispute that the agreement could not be modified, but he contends that "[e]ven assuming, arguendo, that the agreement between Mr. Walley and Mr. Rutherford was ineffective, it would certainly pose a question for the jury as to whether the Rutherfords relied on the representations and whether they were made in order to deceive and lull the Rutherfords into a false sense of security with respect to keeping the vehicle and being allowed to make the payments in several days." Rutherford also argues that the witnesses for Big Three Motors testified

that they were on the way to Hattiesburg, Mississippi, to repossess the vehicle. The Rutherfords argue that Big Three Motors intended to repossess the car on the day it was taken from the possession of Mrs. Rutherford. Further, the Rutherfords assert these actions are indicative of the fact that Big Three Motors had no intention of allowing Mr. Rutherford to wait several days to make his payments and, therefore, that the representations in the agreement to allow him to pay later were made with a fraudulent intent. Rutherford sums up his argument by stating that "[t]he facts clearly show that the repossession conducted by Big Three Motors was conducted by force and with use of trickery and fraud." As we have previously pointed out, the evidence in this case was conflicting and this Court has held on many previous occasions that where the evidence is conflicting, the credibility of the testimony is for the jury. Our review of the record reveals that even though the evidence was conflicting, the Rutherfords introduced ample evidence to support their claims against Big Three Motors. The jury could reasonably conclude and find that Big Three Motors used force, trickery and fraud in the repossession. In short, the evidence was sufficient to show that the actions of the agents of Big Three Motors amounted to a breach of the peace because of the manner in which they pulled Mrs. Rutherford off the road and repossessed her husband's automobile.

TORBERT, Chief Justice (concurring specially).

I agree with the majority that the evidence concerning the manner in which agents of Big Three Motors Company pulled Mrs. Rutherford off the highway and escorted her to the car dealer's office was sufficient to show a breach of the peace under Code 1975, § 7-9-503. I write to point out that any oral offer by Mr. Wally to extend the time of payment would not be enforceable.

2.14.5. WALTER KOUBA v. EAST JOLIET BANK, 135 Ill. App. 3d 264 (1985)

This is an appeal from an order of summary judgment entered in favor of defendants East Joliet Bank and Dave Kiester, d/b/a Kiester's Garage. The bank held a security interest in a Ford Bronco truck purchased by the plaintiffs, Walter and Acelia Kouba. Because the plaintiffs were in default on their monthly loan payments, the bank contracted with Leroy Campbell, d/b/a Recoveries Unlimited, to repossess the truck. Campbell in turn hired defendants Mau, Sullivan and Schroll, who went onto plaintiffs' property to recover the truck. When confronted by the plaintiffs, defendant Mau allegedly grabbed Acelia Kouba by the neck, threw her to the ground and took the truck by force. The repossessors then allegedly started the truck on fire and dropped it off of a tow truck hoist shortly before the police arrived. Later, the vehicle was destroyed by fire while being stored at Kiester's Garage.

Defendants Sullivan and Schroll have never been found for service of summons and were dismissed by plaintiffs. A default judgment was entered against defendants Mau and Campbell.

The plaintiffs submit the following issues on appeal: (1) whether the grant of summary judgment as to the bank contradicts the intent of the Uniform Commercial Code; (2) whether there is an issue of fact as to the bank's vicarious liability for the tortious conduct of the repossessors.

In its motion for summary judgment, the bank argued that there was no genuine issue of fact as to its liability since the pleadings and affidavits established that the repossessors were

independent contractors. The plaintiffs ask this court to ignore agency principles and subject the bank to statutory liability under article 9 of the Uniform Commercial Code. In the alternative, the plaintiffs argue that the doctrine of respondeat superior is applicable to the bank because the repossessors were its agents. Therefore, the bank is liable for the common law torts of the repossessors.

Section 9-503 [now UCC 9-609] of the U.C.C. permits a secured party to take possession of the collateral following default without judicial process if repossession can be accomplished without a breach of the peace. It is beyond dispute that the repossessors hired by the bank caused a breach of the peace in the present case. However, section 9-503 itself does not provide an aggrieved debtor with a cause of action. The remedy is found in section 9-507 [now UCC 9-625], which has been construed as granting statutory relief for any violation of article 9, part 5. This includes a breach of the peace under 9-503.

The statutory remedies are twofold. First, if the collateral is consumer goods, the debtor may recover the credit service charge plus 10% of the principal amount of the debt, plus 10% of the cash price. Second, the secured party may be denied a deficiency judgment.

There are a number of problems with applying these remedies to the present case. Section 9-507, by its terms, applies after disposition of the collateral. There has been no disposition here. There is also a question as to whether 9-507 applies to secured parties in cases where an independent contractor rather than an employee is charged with committing a breach of the peace in violation of section 9-503. There are no Illinois cases on point.

After examining count I of the plaintiffs' complaint, we find that we need not consider the applicability of 9-507. The plaintiffs have failed to specifically plead a statutory remedy under 9-507. Therefore, they must rely on common law remedies for wrongful repossession. The plaintiffs allege that the repossession is wrongful due to the tortious acts of the repossessors, i.e., assault, battery, trespass and conversion. Since we are now dealing with common law rather than statutory liability, we must first determine whether the bank is responsible under the law of agency for the conduct of others.

An employer is generally not liable for the acts of independent contractors. The test of whether one is an independent contractor or employee is the extent of the employer's right to control the manner and method in which the work is to be carried on. We agree with the bank's assertion that the repossessors were independent contractors.

The record reveals that the repossessors were not on the bank's payroll and were paid on a per car, flat-fee basis. The repossessors exercised complete discretion as to how and when the vehicles were to be repossessed and used their own tools and equipment. The bank had no right of control.

The plaintiffs concede that the repossessors fit within the commonly accepted description of an independent contractor but insist that they are also agents and that principals are liable for the torts of their agents. A master is liable for the acts of his servant committed within the scope of employment, and a principal is liable for the acts of an agent performed within the scope of the agency, but neither is liable for the acts of an independent contractor. Therefore, an employer is not responsible for the physical acts of an independent contractor who also happens to possess the powers of an agent.

There are exceptions to the rule which insulate an employer from liability for the acts of an independent contractor, but none are applicable here. An employer could be liable if he fails to exercise reasonable care in selecting a competent contractor or if the employer orders or directs the injurious act. However, the plaintiffs do not allege that the bank was negligent in hiring the repossessors or directed the tortious acts complained of.

The complaint and affidavits fail to raise any genuine issue as to the bank's statutory liability or accountability for the tortious acts of the repossessors. Accordingly, we affirm the order of summary judgment entered in favor of the bank.

JUSTICE STOUDER, dissenting:

I do not agree that the bank has no liability for the acknowledged breach of section 9-503 by breaching the peace in retaking plaintiff's truck. There is no dispute that plaintiff Acelia Kouba was dragged from the truck by her neck during the repossession or that such an action on the part of the repossessors constituted a breach of the peace. The majority relies upon an agency theory to relieve the bank of potential liability seemingly on the premise that because the plaintiff did not specifically plead a remedy under section 9-507 of the Uniform Commercial Code that the Code does not apply and that the common law must be resorted to. Section 9-507 is available "if it is established that the secured party is not proceeding in accordance with the provisions of this Part [part 5]." [An official comment to the UCC] indicates that, contrary to the majority view, section 9-507 encompasses a number of remedies, i.e., conversion and denial of a deficiency judgment, which are not specifically set out in the statute. White and Summers in their treatise on the Uniform Commercial Code discuss at length not only denial of deficiency judgment but possible tort liability incurred by a secured party for a breach of the peace under section 9-503. Therefore, recovery of a liquidated amount is by no means an exclusive remedy for a breach of the peace.

In my opinion, in this case, where there is no dispute that a breach of the peace occurred in the attempted repossession of plaintiff's truck by the bank, the plaintiff has its choice of remedies under 9-507. Merely because the plaintiff may not be effectively compensated by the liquidated amount or there has been no disposition of the collateral does not foreclose recovery under 9-507, nor does it mean that the bank has no liability for failing to comply with 9-503. The proper action in this case, when the collateral has little or no value due to its destruction in the hands of the secured party, is conversion. Because the repossession was not accomplished by lawful means as acknowledged by both parties, the collateral was never rightfully in possession of the bank, although the bank certainly exercised control over the truck. Although there are no cases in Illinois where a debtor has maintained an action for conversion for a breach of the peace under 9-503, there is considerable authority in other jurisdictions for maintaining a conversion suit against a secured party when force or threat of force is used to obtain possession. In Henderson v. Security National Bank (1977), 72 Cal. App.3d 764, 140 Cal. Rptr. 388, a California court confronted the agency argument upon which the majority based its decision and found that conversion "[does] not depend upon authorization, or ratification, or upon the knowledge, or intent, or bad faith of the Bank." In Henderson, the Bank had employed an independent contractor (a licensed repossessor) to repossess plaintiff's Cadillac. The plaintiff alleged that his garage door lock was broken during the repossession of the automobile in violation of section 9-503 of the California Uniform Commercial Code. The court in Henderson found that a conversion action against the bank was proper because "the * * * right of redress [in a conversion action] no longer depends upon his showing * * * that the defendant did the act in question from wrongful motives, or generally

speaking, even intentionally; and hence the want of such motives, or of intention, is no defense." Therefore, this is not a matter of imposing absolute liability on the bank but rather redressing the plaintiff for the injury imposed for the unlawful deprivation of his property.

In my opinion, the bank is liable for the damages to the truck after it wrongfully repossessed the truck. Section 9-503 provides that self-help repossession can only be accomplished if the peace is not breached. Plaintiff had a right to possession of the truck which the bank held unlawfully. The bank prevented operation of section 9-504, not the plaintiff, and is, therefore, liable at a minimum for the diminution in value of the collateral while it was wrongfully held. I believe the plaintiff stated a reasonable theory for recovery against the bank under the Code, and I would reverse the trial court's decision granting summary judgment in favor of the bank.

2.15. Practice Problems: Enforcement of Liens and Claims

Problem 1. Creditor has a security interest in the Debtor's piano. Debtor has defaulted in its obligation to make monthly payments to secured creditor. Can secured creditor enter the Debtor's house at night by picking the lock to repossess the piano? What if the front door was open? Does it matter whether the security agreement allows the creditor to enter the debtor's premises to repossess the collateral? Suppose the piano was in a local repair shop being repaired. Could the creditor enter the repair shop at night to repossess the piano?

> NOTES: *Girard v. Anderson*, 257 N.W. 400, 402–03 (Iowa 1934) (Repossession of a piano by entry through the door of a debtor's residence was found to be a breach of the peace even though the door was supposedly unlocked). *Martin v. Dorn Equip.*, 821 P.2d 1025, 1026–28 (Mont. 1991) (cutting chains connected to a lock is a breach of the peace); *Williamson v. Fowler Toyota, Inc.*, 956 P.2d 858, 859, 862 (Okla. 1998) (cutting gate's chain without permission is a breach of the peace); *Davenport v. Chrysler Credit Corp.*, 818 S.W.2d 23, 26, 29–30 (Tenn. Ct. App. 1991) (entering garage and cutting chains that attached car to post in garage to repossess the car is a breach of the peace).

Problem 2. Debtor purchased a car with financing from CarBank, and failed to make the required payments. Fearing trouble, CarBank hires an off-duty sheriff to show up in uniform to repossess the car. The debtor cooperates and there is no trouble. Has CarBank breached the peace? What if a private repossession agent told the police to stand by out-of-sight in case of trouble during the re-possession?

> NOTES: Assistance of law enforcement is a per se breach of the peace. *See Harris v. City of Roseburg*, 664 F.2d at 1121 (9th Cir. 1981) (no violation where officer out of sight); *Jackson v. Richards*, 433 A.2d 888, 895–96, n.11 (Pa. Super. Ct. 1981); *Stone Mach. Co. v. Kessler*, 1 Wash. App. 750, 757, 463 P.2d 651, 655 (1970).

Problem 3. After repossessing the car, CarBank sells it at a private auction without giving a notice of sale to the debtor. What are the consequences to CarBank of failing to give notice of

the sale to the debtor, if any? Read UCC § 9-610(a) and (b), 9-611(b), 9-625(b) and (e), 9-626(a)(3) and (b).

Problem 4. CarBank sends a letter to the Debtor offering to accept the car in full satisfaction of the debt. The letter says that CarBank's failure to respond within 20 days constitutes acceptance of its offer. Assume that the car is worth more than the debt. Is this effective to terminate the Debtor's equity of redemption? *See* UCC § 9-620 (validating strict foreclosure letters like these, but only if the debtor has not already paid at least 60% of the cash price of the consumer goods); *see also* *Reeves v. Foutz & Tanner*, 94 N.M. 760 (1980).

2.16. Consignments

You are shopping for antique furniture at a retail store. You decide to buy a dining room table for $1,000. Suppose the dealer has borrowed $100,000 from a bank to finance its inventory, and has given the bank a security interest in its inventory, which the bank duly perfected. Also suppose that, unknown to you, the dealer is in default on its financing agreement with the bank. After you have paid for the table and taken it home, a bank officer comes to your house to repossess the table because the dealer was in default under the financing agreement. Do we expect customers like you to search the UCC records before buying furniture from a retail store to assure that they are getting clear title?

The answer to the question is "no." We do not expect customers from retail stores to search UCC records and track the status of the seller's security interests. UCC § 1-201(b)(9) defines you as a "buyer in the ordinary course of business," and UCC § 9-320(a) allows you to take free of any security interest created by the dealer.

Now suppose that you own some antique furniture that you would like to sell. The local furniture dealer tells you that they would be happy to sell the furniture for you for a 20% commission on the sale. The dealer is not buying the furniture from you – you remain the owner of the furniture, and can take the furniture back if the dealer does not sell it. We call this arrangement a "consignment." You are consigning the goods to the dealer for sale. The dealer is the consignee. You retain title and ownership to the goods, while the dealer retains possession of the goods for sale.

A customer coming into the dealer's store has no easy way of knowing whether the furniture belongs to you, as opposed to being inventory of the dealer. What happens if the dealer sells your furniture to a retail buyer without paying you the agreed 80% of the purchase price?

Similarly, now imagine that a bank instead of financing and taking a security interest in the dealer's inventory, buys the inventory directly and consigns that inventory to the dealer. Or the bank financing inventory is unaware that the dealer does not own the inventory because it's consignment property. Now add in lien creditors and the trustee in bankruptcy (who, as we will study in more detail later has the power of a lien creditor under 11 U.S.C. § 544(a) to avoid unperfected security interests), and the situation becomes increasingly complex.

Article 9 of the UCC solves many of the problems by treating many consignments as security interests. Consignments covered by UCC 9-102(a)(20) are security interests, and must be perfected by the consignor to protect the consignor's rights. *In re Faber's*, reprinted below, points

out the danger to consignors who do not file a financing statement to protect their Article 9 security interest. However, some consignments are not covered by UCC Article 9, and are therefore governed by state law. Consignors of non-Article 9 consignments are owners, and may be protected from lien creditors. Read UCC 9-102(a)(20) carefully, and consider when a consignment will be treated as a security interest under Article 9, and when a consignment will not be so treated.

2.16.1. IN RE FABER'S, INC., 360 F. Supp. 946, 12 U.C.C. Rep. Serv. 126 (D. Conn 1972)

The bankrupt is a retail carpet and rug merchant. The petitioner, Mehdi Dilmaghani & Company, Inc. (dealer), shipped oriental rugs to the bankrupt on consignment. All of the rugs had an identifying label attached. On each label was printed "MD. & CO., INC., Reg. No. R.N. 22956, 100% wool pile, No. _____, Quality _____, Size _____, Sq. Feet _____, Made in Iran."

The consignment agreement provided that title to the rugs remained in the dealer until fully paid for; that the consignee had the right to sell the rugs in the ordinary course of business and only at a price in excess of the invoice price; that the proceeds of any sale were the property of the dealer and held in trust for the dealer; that the proceeds of any sale were to be remitted to the dealer immediately with a report of the sale; [and] that all rugs were held at the risk of the consignee.

No effort was made to comply with provisions the of Commercial Code relating to security interests. The dealer does not assert a security interest in the rugs, claiming only that the rugs are and always were the property of the dealer under a "true consignment" and, therefore, not subject to the provisions of the Code relating to security interests. The dealer's claim is that the consignment was not intended for security and is, therefore, not subject to the requirements of Article 9.

The logic of this argument escapes the court. If the dealer did not want the agreement to provide it with security for either the payment of the rugs or their return, what other purpose could there have been? The agreement describes the rugs as belonging to the dealer, but the risk of loss or damage is on the consignee. This is inconsistent with the liability of a bailee. The proceeds of the sales were to be the property of the dealer, but the consignee is described as holding the proceeds in trust. A trustee has title to the trust estate. The agreement impliedly permitted the consignee to mingle the proceeds with his own funds before remitting. At any rate, there was no requirement of a separate account. This is inconsistent with a true trust.

The principal claim of the dealer is [that] the transaction was a true consignment, that at all times the consignee was acting as the agent of the dealer.

To protect itself from the claims of creditors, the dealer could have complied with the filing provisions of Article 9, but it admittedly did not. The only other exception [is] establishing that the consignee-bankrupt was generally known by his creditors to be substantially engaged in selling the goods of others. In support of the latter theory, evidence was submitted that the dealer never dealt in oriental rugs prior to May 1971 and that an advertisement in the local newspapers on October 12, 1971, included a picture of Mr. Mehdi Dilmaghani together with the narrative: "By Special Arrangement, we proudly introduce: A distinctive collection of Mehdi Dilmaghani . . .

renown importer of genuine handmade Oriental, India, and Petit-Point Rugs . . . ." This hardly complies with the requirement that the bankrupt "is generally known by his creditors to be substantially engaged in selling the goods of others." (Emphasis added.) There was no evidence of any notification to any of the bankrupt's creditors to that effect. In fact, it is found that the contrary was true. The bankrupt was not substantially engaged in selling the goods of others.

The dealer argues that the oriental rugs were not the kind of goods in which the bankrupt dealt. They may not have been of the same quality or price range as the other rugs and carpets sold by the bankrupt, but they were all of the same kind of goods — to wit: floor coverings. The trade name of the bankrupt was "Faber's World of Carpets." Other than the reference to the collection by Dilmaghani in the newspaper, there was nothing to suggest any possible connection with the dealer. In fact, this advertisement is no different from that of a department store advertising a full line of "Frigidaire" appliances, or a collection of Pierre Cardin's new spring line.

There was evidence that the members of the Oriental Rug Dealers Association usually sold their rugs on consignment. This was well known to the members of the association. There was no evidence that this was the universal invariable practice in the trade, or that the creditors of the bankrupt who apparently did not deal in oriental rugs knew anything about the custom of the members of the Oriental Rug Dealers Association.

As between the parties, the transaction was a consignment agreement. As to the creditors, it was a sale or return and bound by the provisions of [NYUCC 2-326]. Since the petitioner does not come under the exceptions in this section, it was required to comply with the filing provisions of Article 9 to preserve its secured position. Admittedly, this was not done. Accordingly, the goods are subject to the claims of creditors. The reclamation petition is denied, and it is so ordered.

Chapter 3. The Bankruptcy System

3.1. Purposes of Bankruptcy

As we've seen in the previous chapters, state laws favor the swiftest creditors by granting priority to those unsecured creditors who are first to obtain a judgment, execute on the debtor's assets and cause them to be sold. Meanwhile, debtors can generally prefer favored creditors by preferentially paying their claims or granting them security interests before paying other creditors, even if the preferential payments render the debtor insolvent and unable to pay other claims. The state law process is expensive and time consuming for creditors, and because of the holdout problem makes it difficult for debtors to enter into consensual workouts with creditors.

The state law system also results in creditors (and, if solvent, the debtor) receiving fire sale prices for the debtor's non-exempt assets. Although many states have statutes allowing collective action by creditors (assignments for the benefit of creditors and equity receiverships), these procedures lack the nationwide organizational structure of a national bankruptcy system and also face significant obstacles from the holdout problem.

State laws also provide no ready mechanism for debtor relief outside of the statutes of limitation. There are generally long statutory periods for filing contractual debt collection suits (generally 3-6 years from default), and even longer periods (generally 10 or more years) for collecting judgments. In some states, like New York, the debtor can unwittingly revive an expired limitations period by acknowledging the debt. New York General Obligations Law 17-101. In New York, any payment on a debt – even one that could not be collected in court due to the expiration of the statute of limitations - renews the entire liability and starts a new limitations period if the court determines that the partial payment constitutes an acknowledgment of the debt. *See Empire Purveyors v. Weinberg*, No. 603282/06, 2008 N.Y. Misc LEXIS 8842, 2008 Slip Op 31380U (N.Y. Co. 2008), aff'd, 60 A.D.3d 508, 885 N.Y.S.2d 905 (1st Dept. 2009). Debt collectors often request a small token payment, claiming that it would be a sign of good faith, when in fact they are seeking to extend or renew a limitations period that that debtor did not know expired and was not intending to renew. In many states the judgment limitation periods can be extended by filing renewal suits before the limitations period expires, potentially saddling a debtor with liability for a lifetime. The statute of limitations on the enforcement of liens can run for a decade or more. Statute of limitations periods thus provide only limited relief for debtors.

Debtors saddled with debts that they are unable to pay are discouraged from engaging in gainful employment when much of the benefit would go to the debtor's creditors, creating a cycle of poverty. Debtors who know that they would be unable to rid themselves of debt may be unable or unwilling to incur debt for entrepreneurial investment, hampering the growth of the economy. For these basic reasons, successful economies have recognized that debt relief is an important ingredient for both fairness and economic growth.

The bankruptcy system is designed to pick up where state law leaves off by providing for orderly collective creditor action, providing for the discharge of debts that are not paid through the bankruptcy process, and addressing the holdout problem by facilitating orderly and fair reorganization proceedings. In liquidation cases, an independent trustee will have time to achieve high sale prices, and the distribution rules assure that similarly situated creditors will be treated

similarly. Individual debtors can receive a discharge of their debts, allowing them to receive a fresh start and return as productive members of society. In reorganization cases, creditors are assured of receiving more than they would receive in a liquidation, and are protected by detailed rules designed to assure a measure of fairness to all parties. All parties are also protected by a legal framework designed to provide full and prompt financial disclosure by the debtor, and an expeditious hearing process before specialized bankruptcy judges who are experts in bankruptcy law to resolve any disputes that may arise.

3.2. Structure of the Bankruptcy Code

The federal bankruptcy system is grounded on a grant of power contained in the United States Constitution. The grant gave Congress the power to create "uniform laws on the subject of bankruptcies." While there were long periods during the 18th and 19th Centuries during which Congress decided not to enact uniform bankruptcy laws, there has been a continuous federal bankruptcy system in effect since 1898.

Congress revamped the bankruptcy laws in 1978 by passing the Bankruptcy Reform Act of 1978 (Pub.L. 95–598, 92 Stat. 2549, November 6, 1978), which has become known simply as the "Bankruptcy Code" or "Code," and will be referred to as such throughout this book.

The original structure of the Code remains intact, although there have been several significant amendments, the most significant being the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109–8, 119 Stat. 23, known as "BAPCPA." BAPCPA was a poorly drafted law cobbled together by special interests without the usual vetting process by the bankruptcy bench and bar that had been used in previous amendments. Major portions of BAPCPA did not go into effect immediately, and the media spread alarm that bankruptcy would no longer be available to consumer debtors, resulting in a tremendous rush by individuals to file prior to the effective date. As a result, nearly 2 million people filed bankruptcy in 2006, with bankruptcy lawyers serving lines of people waiting to get their cases filed before the deadline.

In fact, as we will see, while the law created a great deal of unnecessary paperwork and complexity, and substituted rigid tests that are easily circumvented for the flexible tests that the courts used previously, the law did not disqualify most of the people who need relief from eligibility. However, BAPCPA's complexity and confusion have made it more difficult for general practitioners to handle bankruptcy cases part time. The bankruptcy bar has become smaller and more specialized as a result of BAPCPA. We will look in this chapter at some of the most significant changes wrought by BAPCPA, including the dreaded "means test" and the automatic dismissal rules.

The Bankruptcy Code is Title 11 of the United States Code. It is divided into chapters – all odd numbers except Chapter 12. Chapters 1, 3 and 5 contain general rules applicable to each of the remaining chapter proceedings. Cases are filed under a specific chapter proceeding:

Chapter 7: Straight bankruptcy liquidation

Chapter 9: Municipalities (government entities)

Chapter 11: Business reorganizations

Chapter 12: Family farmer and fisherman reorganizations

Chapter 13: Mostly consumer reorganizations

Chapter 15: Transnational reorganizations

Chapter 7 is what most people think bankruptcy is about. The debtor turns over all of his, her or its non-exempt assets to an independent Chapter 7 trustee. The trustee liquidates the assets (turns them into money usually by selling them), and uses the proceeds of the liquidation pay claims in an order of priority: expenses of liquidation and administration first, certain priority claims second, and then general unsecured claims. Individual debtors receive a discharge of their debts. Entity debtors become empty shells and for all practical purposes suffer corporate death. A better term may be corporate zombies, since the entity must technically be wound up and terminated under state law to cease to exist, but they are empty shell entities that cannot generally be used for any other purpose since the shells continue to owe all unpaid creditors. Chapter 7 proceedings are fast, with most cases completed within four to six months after filing.

Until recently, Chapter 9 was a sleepy and ill-defined chapter of the Bankruptcy Code. Recently, however, it has become a hotbed of activity, with major cities like Detroit, Michigan, filing for bankruptcy relief, and great uncertainty about what can be done to revitalize moribund governmental entities. These cases pit former government workers relying on promised pensions against bondholders, creditors, continuing workers and taxpayers. Many municipalities appear to be sitting on the sidelines awaiting clarity from the courts about what can be done in a Chapter 9 case.

Chapter 11 is the most important reorganization chapter in terms of the amount of money at stake, but involves only a tiny fraction of the cases that are filed each year. Chapter 11 is expensive. Even small simple Chapter 11 cases can cost $100,000 in fees, and large cases can cost hundreds of millions of dollars in fees. Chapter 11 cases pit the largest and most expensive law and investment firms in the country against each other. Chapter 11 is designed for flexibility, allowing virtually limitless reorganization agreements to be reached between creditors and debtors, and overcoming the holdout problem with a special majority voting structure. Because of its flexibility and consequent expense, Chapter 11 is appropriate only for individuals or businesses seeking to reorganize significant assets.

Almost anything can be done to reorganize a debtor in Chapter 11 with the requisite levels of consent from creditors. The trick is proposing a plan which will cause as much pain to creditors as possible while still receiving the affirmative votes of the requisite majorities. Debtors who cannot obtain the requisite votes must “cramdown” the plan on non-consenting classes of creditors in the limited ways allowed by the bankruptcy code.

While lawyers handling Chapter 11 cases perform legal work that is custom tailed to the particular case, those handling Chapter 12 and 13 cases work from an off-the-rack reorganization plan structure. Like Chapter 7, Chapters 12 and 13 are structured simply, limiting what the debtor can do to reorganize its business. There is no voting and no need to reach agreements with the majority of creditors – the plan either meets the requirements for confirmation or it does not, and the bankruptcy law says what can and cannot be done to restructure creditor claims.

Chapter 15 is a new provision for foreign parties that have filed a bankruptcy or bankruptcy-like proceeding in another country to obtain assistance through an ancillary proceeding in the United States to deal with assets located in the United States.

3.3. Jurisdiction and Venue of Bankruptcy Cases

The Bankruptcy Code has been plagued by jurisdictional uncertainty since it was enacted. The main source of dispute has been the tension between Congress's power under Article I of the Constitution to create uniform bankruptcy laws, and the requirements of Article III for an independent judiciary. The tension results from Congress's decision not to form the bankruptcy courts in conformity with the mandates of Article III – specifically, bankruptcy judges do not have life tenure and un-diminishable salaries as required by Article III. Ironically, Congress's decision not to establish the bankruptcy courts under Article III was made to placate the existing Article III judiciary who felt that their prestige and power would be diminished by the granting of Article III status to the large number of bankruptcy judges needed to administer the bankruptcy system.

The entire bankruptcy system was plunged into a crisis in 1982 (only four years after the enactment of the new law) when the Supreme Court issued its famous decision in *Northern Pipeline*, printed below, holding that the bankruptcy system was unconstitutional because it gave the non-Article 3 bankruptcy judges the power to adjudicate an ordinary breach of contract dispute.

It is important to distinguish the bankruptcy jurisdictional problem (Article I v. Article III) from the normal subject matter jurisdiction issue involving the power of the federal government *vis a vis* the states (which cannot be waived by the litigants since it involves state rights). What is at stake under Article 1 is the litigant's constitutional right to have a judge with the protections of life tenure and un-diminishable salary decide the case. Congress could easily cure the Article 1 problem by endowing bankruptcy judges with the protections of Article III, but that solution has not been in the political cards, so doubts about the constitutionality of the bankruptcy system persist.

3.4. Cases on the Constitutional Limits of Bankruptcy Jurisdiction

3.4.1. NORTHERN PIPELINE CO. v. MARATHON PIPE LINE CO., 458 U.S. 50 (1982)

JUSTICE BRENNAN

The question presented is whether the assignment by Congress to bankruptcy judges of the jurisdiction granted in 28 U.S.C. § 1471 (1976 ed., Supp. IV) by § 241(a) of the Bankruptcy Act of 1978 violates Art. III of the Constitution.

In 1978, after almost 10 years of study and investigation, Congress enacted a comprehensive revision of the bankruptcy laws. The Bankruptcy Act of 1978 (Act) made significant changes in both the substantive and procedural law of bankruptcy. It is the changes in the latter that are at issue in this case.

Before the Act, federal district courts served as bankruptcy courts and employed a "referee" system. Bankruptcy proceedings were generally conducted before referees, except in those instances in which the district court elected to withdraw a case from a referee. The referee's final order was appealable to the district court. The bankruptcy courts were vested with "summary jurisdiction"—that is, with jurisdiction over controversies involving property in the actual or constructive possession of the court. And, with consent, the bankruptcy court also had jurisdiction over some "plenary" matters—such as disputes involving property in the possession of a third person.

The Act eliminates the referee system and establishes "in each judicial district, as an adjunct to the district court for such district, a bankruptcy court which shall be a court of record known as the United States Bankruptcy Court for the district." The judges of these courts are appointed to office for 14-year terms by the President, with the advice and consent of the Senate. They are subject to removal by the "judicial council of the circuit" on account of "incompetency, misconduct, neglect of duty or physical or mental disability." In addition, the salaries of the bankruptcy judges are set by statute and are subject to adjustment under the Federal Salary Act.

The jurisdiction of the bankruptcy courts created by the Act is much broader than that exercised under the former referee system. Eliminating the distinction between "summary" and "plenary" jurisdiction, the Act grants the new court's jurisdiction over all "civil proceedings arising under title 11 or arising in or related to cases under title 11." This jurisdictional grant empowers bankruptcy courts to entertain a wide variety of cases involving claims that may affect the property of the estate once a petition has been filed under Title 11. The bankruptcy courts can hear claims based on state law as well as those based on federal law.

This case arises out of proceedings initiated after appellant Northern filed a petition for reorganization in January 1980. In March 1980 Northern, pursuant to the Act, filed in that court a suit against appellee Marathon. Appellant sought damages for alleged breaches of contract and warranty, as well as for alleged misrepresentation, coercion, and duress. Marathon sought dismissal of the suit, on the ground that the Act unconstitutionally conferred Art. III judicial power upon judges who lacked life tenure and protection against salary diminution.

"A Judiciary free from control by the Executive and Legislature is essential if there is a right to have claims decided by judges who are free from potential domination by other branches of government." *United States v. Will*, 449 U.S. 200, 217-218 (1980). As an inseparable element of the constitutional system of checks and balances, and as a guarantee of judicial impartiality, Art. III both defines the power and protects the independence of the Judicial Branch. The judicial power of the United States must be exercised by courts having the attributes prescribed in Art. III.

It is undisputed that the bankruptcy judges whose offices were created by the Bankruptcy Act of 1978 do not enjoy the protections constitutionally afforded to Art. III judges.

Appellants suggest two grounds for upholding the Act's conferral of broad adjudicative powers upon judges unprotected by Art. III. First, it is urged that Congress may establish legislative courts that have jurisdiction to decide cases to which the Article III judicial power of the United States extends. Second, appellants contend that even if the Constitution does require that this bankruptcy-related action be adjudicated in an Art. III court, the Act in fact satisfies that requirement. [T]he exercise of [bankruptcy] jurisdiction by the adjunct bankruptcy court was made subject to appeal as of right to an Article III court. Analogizing the role of the bankruptcy court to

that of a special master, appellants urge us to conclude that this system established by Congress satisfies the requirements of Art. III. We consider these arguments in turn.

Congress did not constitute the bankruptcy courts as legislative courts. Appellants contend, however, that the bankruptcy courts could have been so constituted, and that as a result the "adjunct" system in fact chosen by Congress does not impermissibly encroach upon the judicial power.

[There are only] three narrow situations in which the grant of power to the Legislative and Executive Branches was historically and constitutionally so exceptional that the congressional assertion of a power to create legislative courts was consistent with, rather than threatening to, the constitutional mandate of separation of powers. [The court discusses territorial courts applying outside of the home jurisdiction of the United States, courts martial involving the military, and public rights courts involving claims against the United States government to recover money.]

We discern no such exceptional grant of power applicable in the cases before us. The courts created by the Bankruptcy Act of 1978 do not lie exclusively outside the States of the Federal Union. Nor do the bankruptcy courts bear any resemblance to courts-martial, which are founded upon the Constitution's grant of plenary authority over the Nation's military forces to the Legislative and Executive Branches. Finally, the substantive legal rights at issue in the present action cannot be deemed "public rights."

Recognizing that the present cases may not fall within the scope of any of our prior cases permitting the establishment of legislative courts, appellants argue that we should recognize an additional situation beyond the command of Art. III, sufficiently broad to sustain the Act. Appellants contend that Congress' constitutional authority to establish "uniform Laws on the subject of Bankruptcies throughout the United States," Art. I, § 8, cl. 4, carries with it an inherent power to establish legislative courts capable of adjudicating "bankruptcy-related controversies." In support of this argument, appellants [argue] that a bankruptcy court created by Congress under its Art. I powers is constitutional, because the law of bankruptcy is a "specialized area," and Congress has found a "particularized need" that warrants "distinctive treatment."

Appellants' contention, in essence, is that pursuant to any of its Art. I powers, Congress may create courts free of Art. III's requirements whenever it finds that course expedient. This contention has been rejected in previous cases. Although the cases relied upon by appellants demonstrate that independent courts are not required for all federal adjudications, those cases also make it clear that where Art. III does apply, all of the legislative powers specified in Art. I and elsewhere are subject to it. The flaw in appellants' analysis is that it provides no limiting principle. It thus threatens to supplant completely our system of adjudication in independent Art. III tribunals and replace it with a system of "specialized" legislative courts. True, appellants argue that under their analysis Congress could create legislative courts pursuant only to some "specific" Art. I power, and "only when there is a particularized need for distinctive treatment." They therefore assert that their analysis would not permit Congress to replace the independent Art. III Judiciary through a "wholesale assignment of federal judicial business to legislative courts." But these "limitations" are wholly illusory [citing the broad powers given to Congress under Article I). The potential for encroachment upon powers reserved to the Judicial Branch through the device of "specialized" legislative courts is dramatically evidenced in the jurisdiction granted to the courts created by the Act before us. The broad range of questions that can be brought into a bankruptcy

court because they are "related to cases under title 11" is the clearest proof that even when Congress acts through a "specialized" court, and pursuant to only one of its many Art. I powers, appellants' analysis fails to provide any real protection against the erosion of Art. III jurisdiction by the unilateral action of the political Branches. In short, to accept appellants' reasoning, would require that we replace the principles delineated in our precedents, rooted in history and the Constitution, with a rule of broad legislative discretion that could effectively eviscerate the constitutional guarantee of an independent Judicial Branch of the Federal Government.

In sum, Art. III bars Congress from establishing legislative courts to exercise jurisdiction over all matters related to those arising under the bankruptcy laws. The establishment of such courts does not fall within any of the historically recognized situations in which the general principle of independent adjudication commanded by Art. III does not apply. Nor can we discern any persuasive reason, in logic, history, or the Constitution, why the bankruptcy courts here established lie beyond the reach of Art. III.

Appellants advance a second argument for upholding the constitutionality of the Act: that "viewed within the entire judicial framework set up by Congress," the bankruptcy court is merely an "adjunct" to the district court, and that the delegation of certain adjudicative functions to the bankruptcy court is accordingly consistent with the principle that the judicial power of the United States must be vested in Art. III courts. As support for their argument, appellants rely principally upon cases in which we approved the use of administrative agencies and magistrates as adjuncts to Art. III courts. Congress possesses broad discretion to assign fact-finding functions to an adjunct created to aid in the adjudication of congressionally created statutory rights, Congress [does not] possess the same degree of discretion in assigning traditionally judicial power to adjuncts engaged in the adjudication of rights not created by Congress. When Congress creates a statutory right, it clearly has the discretion, in defining that right, to create presumptions, or assign burdens of proof, or prescribe remedies; it may also provide that persons seeking to vindicate that right must do so before particularized tribunals created to perform the specialized adjudicative tasks related to that right. Such provisions do, in a sense, affect the exercise of judicial power, but they are also incidental to Congress' power to define the right that it has created. No comparable justification exists, however, when the right being adjudicated is not of congressional creation.

The Bankruptcy Act vests all "essential attributes" of the judicial power of the United States in the "adjunct" bankruptcy court. First, the subject-matter jurisdiction of the bankruptcy courts encompasses not only traditional matters of bankruptcy, but also "all civil proceedings arising under title 11 or arising in or related to cases under title 11." Second, the bankruptcy courts exercise "all of the jurisdiction" conferred by the Act on the district courts [not just a fact-finding function]. Third, the bankruptcy courts exercise all ordinary powers of district courts, including the power to preside over jury trials, the power to issue declaratory judgments, the power to issue writs of habeas corpus, and the power to issue any order, process, or judgment appropriate for the enforcement of the provisions of Title 11. Fourth, the judgments of the bankruptcy courts are apparently subject to review only under the deferential "clearly erroneous" standard. Finally, the bankruptcy courts issue final judgments, which are binding and enforceable even in the absence of an appeal. In short, the "adjunct" bankruptcy courts created by the Act exercise jurisdiction behind the facade of a grant to the district courts, and are exercising powers far greater than those lodged in the adjuncts approved [in our prior decisions.]

We conclude that the Bankruptcy Act of 1978 has impermissibly removed most, if not all, of "the essential attributes of the judicial power" from the Art. III district court, and has vested those attributes in a non-Art. III adjunct. Such a grant of jurisdiction cannot be sustained as an exercise of Congress' power to create adjuncts to Art. III courts.

Having concluded that the broad grant of jurisdiction to the bankruptcy courts is unconstitutional, we must now determine whether our holding should be applied retroactively to the effective date of the Act. . . . We hold, therefore, that our decision today shall apply only prospectively.

The judgment of the District Court is affirmed. However, we stay our judgment until October 4, 1982. This limited stay will afford Congress an opportunity to reconstitute the bankruptcy courts or to adopt other valid means of adjudication, without impairing the interim administration of the bankruptcy laws.

It is so ordered.

3.5. The Aftermath of *Northern Pipeline*

In *Northern Pipeline*, the Supreme Court took the highly unusual step of allowing the unconstitutional bankruptcy court system to continue operating by staying its decision to allow Congress time to fix the jurisdictional problem. After Congress continued to diddle, the Supreme Court granted a further stay of its decision to December 24, 1982, hoping that Congress would reach agreement on a bankruptcy bill before then. No resolution could be reached, and the Bankruptcy Courts were set to be closed on Christmas Day, December 25, 1982.

To avert the crises that would be caused by the closure of the Bankruptcy Court system, every District Court in the country passed an “emergency rule” drafted by a group of judges in last minute negotiations. The emergency rule required each District Court to appoint the Bankruptcy Judges as “adjuncts,” operating under a modified jurisdictional scheme.

In 1984, Congress codified the emergency rule into 28 U.S.C. Section 157, under which the Bankruptcy Courts now operate. The new jurisdictional scheme allows but does not require the District Courts to refer bankruptcy matters to the Bankruptcy Courts, but every District Court in the country promptly followed the procedure by issuing a general order referring all bankruptcy cases to the Bankruptcy Courts.

The new jurisdictional scheme creates two classes of matters that may come before the Bankruptcy Courts: “core matters” that the Bankruptcy Courts can finally decide subject to appeal, and “non-core related” matters that the Bankruptcy Courts can hear, but can only issue proposed findings of fact and conclusions of law to the District Courts for final determination. However, the list of “core matters” was (and is) quite broad raising the specter of further clashes in the Supreme Court. The bankruptcy world braced for another eminent crisis in the Supreme Court, but what followed was more than 20 years of silence. After the procedural mess that followed the *Marathon* decision, the Supreme Court simply refused to hear any major challenges to the Bankruptcy Court’s jurisdictional scheme – until recently. The silence came to an end in the next two cases, which have left many in the bankruptcy community wondering exactly what the non-Article III bankruptcy court can and cannot do.

3.6. Cases on the Constitutional Limits of Bankruptcy Jurisdiction after *Marathon*

3.6.1. STERN v. MARSHALL, 564 U.S. 462, 131 S.Ct. 2594 (2011)

CHIEF JUSTICE ROBERTS

This "suit has, in course of time, become so complicated, that ... no two ... lawyers can talk about it for five minutes, without coming to a total disagreement as to all the premises. Innumerable children have been born into the cause: innumerable young people have married into it;" and, sadly, the original parties "have died out of it." A "long procession of [judges] has come in and gone out" during that time, and still the suit "drags its weary length before the Court."

Those words were not written about this case, see C. Dickens, Bleak House, in 1 Works of Charles Dickens 4-5 (1891), but they could have been. This is the second time we have had occasion to weigh in on this long-running dispute between Vickie Lynn Marshall and E. Pierce Marshall over the fortune of J. Howard Marshall II, a man believed to have been one of the richest people in Texas. The Marshalls' litigation has worked its way through state and federal courts in Louisiana, Texas, and California, and two of those courts—a Texas state probate court and the Bankruptcy Court for the Central District of California—have reached contrary decisions on its merits. The Court of Appeals below held that the Texas state decision controlled, after concluding that the Bankruptcy Court lacked the authority to enter final judgment on a counterclaim that Vickie brought against Pierce in her bankruptcy proceeding. To determine whether the Court of Appeals was correct in that regard, we must resolve two issues: (1) whether the Bankruptcy Court had the statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie's counterclaim; and (2) if so, whether conferring that authority on the Bankruptcy Court is constitutional.

Although the history of this litigation is complicated, its resolution ultimately turns on very basic principles. Article III, § 1, of the Constitution commands that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." That Article further provides that the judges of those courts shall hold their offices during good behavior, without diminution of salary. Those requirements of Article III were not honored here. The Bankruptcy Court in this case exercised the judicial power of the United States by entering final judgment on a common law tort claim, even though the judges of such courts enjoy neither tenure during good behavior nor salary protection. We conclude that, although the Bankruptcy Court had the statutory authority to enter judgment on Vickie's counterclaim, it lacked the constitutional authority to do so.

Of current relevance are two claims Vickie filed in an attempt to secure half of J. Howard's fortune. Known to the public as Anna Nicole Smith, Vickie was J. Howard's third wife and married him about a year before his death. Although J. Howard bestowed on Vickie many monetary and other gifts during their courtship and marriage, he did not include her in his will. Before J. Howard passed away, Vickie filed suit in Texas state probate court, asserting that Pierce—J. Howard's younger son—fraudulently induced J. Howard to sign a living trust that did not include her, even though J. Howard meant to give her half his property. Pierce denied any fraudulent activity and defended the validity of J. Howard's trust and, eventually, his will.

After J. Howard's death, Vickie filed a petition for bankruptcy in the Central District of California. Pierce filed a complaint in that bankruptcy proceeding, contending that Vickie had defamed him by inducing her lawyers to tell members of the press that he had engaged in fraud to gain control of his father's assets. The complaint sought a declaration that Pierce's defamation claim was not dischargeable in the bankruptcy proceedings. Pierce subsequently filed a proof of claim for the defamation action, meaning that he sought to recover damages for it from Vickie's bankruptcy estate. Vickie responded to Pierce's initial complaint by asserting truth as a defense to the alleged defamation and by filing a counterclaim for tortious interference with the gift she expected from J. Howard. As she had in state court, Vickie alleged that Pierce had wrongfully prevented J. Howard from taking the legal steps necessary to provide her with half his property

On November 5, 1999, the Bankruptcy Court issued an order granting Vickie summary judgment on Pierce's claim for defamation. On September 27, 2000, after a bench trial, the Bankruptcy Court issued a judgment on Vickie's counterclaim in her favor. The court later awarded Vickie over $400 million in compensatory damages and $25 million in punitive damages.

In post-trial proceedings, Pierce argued that the Bankruptcy Court lacked jurisdiction over Vickie's counterclaim. In particular, Pierce renewed a claim he had made earlier in the litigation, asserting that the Bankruptcy Court's authority over the counterclaim was limited because Vickie's counterclaim was not a "core proceeding." The Bankruptcy Court in this case concluded that Vickie's counterclaim was "a core proceeding" under [28 U.S.C.} § 157(b)(2)(C), and the court therefore had the "power to enter judgment" on the counterclaim under § 157(b)(1).

The District Court disagreed. It . . . understood this Court's precedent to "suggest[] that it would be unconstitutional to hold that any and all counterclaims are core." 264 B.R. 609, 629-630 (C.D. Cal. 2001). Because the District Court concluded that Vickie's counterclaim was not core, the court determined that it was required to treat the Bankruptcy Court's judgment as "proposed[,] rather than final," and engage in an "independent review" of the record. Although the Texas state court had by that time conducted a jury trial on the merits of the parties' dispute and entered a judgment in Pierce's favor, the District Court declined to give that judgment preclusive effect and went on to decide the matter itself. Like the Bankruptcy Court, the District Court found that Pierce had tortiously interfered with Vickie's expectancy of a gift from J. Howard. The District Court awarded Vickie compensatory and punitive damages, each in the amount of $44,292,767.33.

The Court of Appeals reversed the District Court on a different ground, and we—in the first visit of the case to this Court—reversed the Court of Appeals on that issue. On remand from this Court, the Court of Appeals held that § 157 mandated "a two-step approach" under which a bankruptcy judge may issue a final judgment in a proceeding only if the matter both "meets Congress' definition of a core proceeding *and* arises under or arises in title 11," the Bankruptcy Code. The court also reasoned that allowing a bankruptcy judge to enter final judgments on all counterclaims raised in bankruptcy proceedings "would certainly run afoul" of this Court's decision in *Northern Pipeline*. With those concerns in mind, the court concluded that "a counterclaim under § 157(b)(2)(C) is properly a `core' proceeding `arising in a case under' the [Bankruptcy] Code only if the counterclaim is so closely related to [a creditor's] proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself." The court ruled that Vickie's counterclaim did not meet that test. That holding made "the Texas probate court's judgment ... the earliest final judgment entered on matters relevant to this proceeding," and therefore the Court of Appeals concluded that the District Court should have

"afford[ed] preclusive effect" to the Texas "court's determination of relevant legal and factual issues."

[The Court then reviewed the operation of 28 U.S.C. § 157.]

Vickie's counterclaim against Pierce for tortious interference is a "core proceeding" under the plain text of § 157(b)(2)(C). That provision specifies that core proceedings include "counterclaims by the estate against persons filing claims against the estate." In past cases, we have suggested that a proceeding's "core" status alone authorizes a bankruptcy judge, as a statutory matter, to enter final judgment in the proceeding. We have not directly addressed the question, however, and Pierce argues that a bankruptcy judge may enter final judgment on a core proceeding only if that proceeding also "aris[es] in" a Title 11 case or "aris[es] under" Title 11 itself.

[The Court concludes that all proceedings that “arise under” or “arise in a case under” Title 11 are “Core Proceedings” within the meaning of 28 U.S.C. § 157, and that only matters merely “related to” Title 11 are non-core matters.]

Pierce argues, as another alternative to reaching the constitutional question, that the Bankruptcy Court lacked jurisdiction to enter final judgment on his defamation claim. Section 157(b)(5) provides that "[t]he district court shall order that personal injury tort and wrongful death claims shall be tried in the district court in which the bankruptcy case is pending, or in the district court in the district in which the claim arose." Pierce asserts that his defamation claim is a "personal injury tort," that the Bankruptcy Court therefore had no jurisdiction over that claim, and that the court therefore necessarily lacked jurisdiction over Vickie's counterclaim as well. Vickie contends that § 157(b)(5) simply specifies the venue in which "personal injury tort and wrongful death claims" should be tried. Given the limited scope of that provision, Vickie argues, a party may waive or forfeit any objections under § 157(b)(5), in the same way that a party may waive or forfeit an objection to the bankruptcy court finally resolving a non-core claim. Vickie asserts that in this case Pierce consented to the Bankruptcy Court's adjudication of his defamation claim, and forfeited any argument to the contrary, by failing to seek withdrawal of the claim until he had litigated it before the Bankruptcy Court for 27 months. On the merits, Vickie contends that the statutory phrase "personal injury tort and wrongful death claims" does not include non-physical torts such as defamation.

We need not determine what constitutes a "personal injury tort" in this case because we agree with Vickie that § 157(b)(5) is not jurisdictional, and that Pierce consented to the Bankruptcy Court's resolution of his defamation claim.

We agree with Vickie that Pierce not only could but did consent to the Bankruptcy Court's resolution of his defamation claim. . . . Pierce identifies no point in the record where he argued to the Bankruptcy Court that it lacked the authority to adjudicate his proof of claim because the claim sought recompense for a personal injury tort. Indeed, Pierce apparently did not object to any court that § 157(b)(5) prohibited the Bankruptcy Court from resolving his defamation claim until over two years—and several adverse discovery rulings—after he filed that claim in June 1996. Given Pierce's course of conduct before the Bankruptcy Court, we conclude that he consented to that court's resolution of his defamation claim (and forfeited any argument to the contrary). . . . Instead,

Pierce repeatedly stated to the Bankruptcy Court that he was happy to litigate there. We will not consider his claim to the contrary, now that he is sad.

Although we conclude that § 157(b)(2)(C) permits the Bankruptcy Court to enter final judgment on Vickie's counterclaim, Article III of the Constitution does not.

[The Court then reviewed its prior jurisdictional decisions through *Northern Pipeline*]

After our decision in *Northern Pipeline,* Congress revised the statutes governing bankruptcy jurisdiction and bankruptcy judges. In the 1984 Act, Congress provided that the judges of the new bankruptcy courts would be appointed by the courts of appeals for the circuits in which their districts are located. 28 U.S.C. § 152(a). And, as we have explained, Congress permitted the newly constituted bankruptcy courts to enter final judgments only in "core" proceedings.

With respect to such "core" matters, however, the bankruptcy courts under the 1984 Act exercise the same powers they wielded under the Bankruptcy Act of 1978 (1978 Act), 92 Stat. 2549. As in Northern *Pipeline,* for example, the newly constituted bankruptcy courts are charged under § 157(b)(2)(C) with resolving "[a]ll matters of fact and law in whatever domains of the law to which" a counterclaim may lead. As in *Northern Pipeline,* the new courts in core proceedings "issue final judgments, which are binding and enforceable even in the absence of an appeal." And, as in *Northern Pipeline,* the district courts review the judgments of the bankruptcy courts in core proceedings only under the usual limited appellate standards. That requires marked deference to, among other things, the bankruptcy judges' findings of fact. See Fed. Rule Bkrtcy. Proc. 8013 (findings of fact "shall not be set aside unless clearly erroneous").

Vickie and the dissent argue that the Bankruptcy Court's entry of final judgment on her state common law counterclaim was constitutional, despite the similarities between the bankruptcy courts under the 1978 Act and those exercising core jurisdiction under the 1984 Act. We disagree. It is clear that the Bankruptcy Court in this case exercised the "judicial Power of the United States" in purporting to resolve and enter final judgment on a state common law claim, just as the court did in *Northern Pipeline.* . . . Here Vickie's claim is a state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor's proof of claim in bankruptcy.

Nor can the bankruptcy courts under the 1984 Act be dismissed as mere adjuncts of Article III courts, any more than could the bankruptcy courts under the 1978 Act. The judicial powers the courts exercise in cases such as this remain the same, and a court exercising such broad powers is no mere adjunct of anyone. . . .

Vickie's claimed right to relief does not flow from a federal statutory scheme. It is not "completely dependent upon" adjudication of a claim created by federal law. And Pierce did not truly consent to resolution of Vickie's claim in the bankruptcy court proceedings. He had nowhere else to go if he wished to recover from Vickie's estate.

Furthermore, the asserted authority to decide Vickie's claim is not limited to a "particularized area of the law." This is not a situation in which Congress devised an "expert and inexpensive method for dealing with a class of questions of fact which are particularly suited to examination and determination by an administrative agency specially assigned to that task." The

"experts" in the federal system at resolving common law counterclaims such as Vickie's are the Article III courts, and it is with those courts that her claim must stay.

We recognize that there may be instances in which the distinction between public and private rights—at least as framed by some of our recent cases—fails to provide concrete guidance as to whether, for example, a particular agency can adjudicate legal issues under a substantive regulatory scheme. Given the extent to which this case is so markedly distinct from the agency cases discussing the public rights exception in the context of such a regime, however, we do not in this opinion express any view on how the doctrine might apply in that different context.

What is plain here is that this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment *by a court* with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime. If such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous "public right," then Article III would be transformed from the guardian of individual liberty and separation of powers we have long recognized into mere wishful thinking.

Vickie and the dissent next attempt to distinguish *Northern Pipeline* on the ground that Pierce . . . had filed a proof of claim in the bankruptcy proceedings. Given Pierce's participation in those proceedings, Vickie argues, the Bankruptcy Court had the authority to adjudicate her counterclaim under our decisions in *Katchen v. Landy*, 382 U.S. 323, 86 S. Ct. 467, 15 L.Ed.2d 391 (1966), and *Langenkamp v. Culp*, 498 U.S. 42, 111 S. Ct. 330, 112 L.Ed.2d 343 (1990) (*per curiam*).

We do not agree. As an initial matter, it is hard to see why Pierce's decision to file a claim should make any difference with respect to the characterization of Vickie's counterclaim. "`[P]roperty interests are created and defined by state law,' and `[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.'" Pierce's claim for defamation in no way affects the nature of Vickie's counterclaim for tortious interference as one at common law that simply attempts to augment the bankruptcy estate—the very type of claim that we held in *Northern Pipeline* must be decided by an Article III court.

Contrary to Vickie's contention, moreover, our decisions in *Katchen* and *Langenkamp* do not suggest a different result. *Katchen* permitted a bankruptcy referee acting under the Bankruptcy Acts of 1898 and 1938 (akin to a bankruptcy court today) to exercise what was known as "summary jurisdiction" over a voidable preference claim brought by the bankruptcy trustee against a creditor who had filed a proof of claim in the bankruptcy proceeding. A voidable preference claim asserts that a debtor made a payment to a particular creditor in anticipation of bankruptcy, to in effect increase that creditor's proportionate share of the estate. The preferred creditor's claim in bankruptcy can be disallowed as a result of the preference, and the amounts paid to that creditor can be recovered by the trustee.

Although the creditor in *Katchen* objected that the preference issue should be resolved through a "plenary suit" in an Article III court, this Court concluded that summary adjudication in bankruptcy was appropriate, because it was not possible for the referee to rule on the creditor's proof of claim without first resolving the voidable preference issue. There was no question that the bankruptcy referee could decide whether there had been a voidable preference in determining

whether and to what extent to allow the creditor's claim. Once the referee did that, "nothing remains for adjudication in a plenary suit"; such a suit "would be a meaningless gesture." The plenary proceeding the creditor sought could be brought into the bankruptcy court because "the same issue [arose] as part of the process of allowance and disallowance of claims."

It was in that sense that the Court stated that "he who invokes the aid of the bankruptcy court by offering a proof of claim and demanding its allowance must abide the consequences of that procedure." Our *per curiam* opinion in *Langenkamp* is to the same effect. . . .

In ruling on Vickie's counterclaim, the Bankruptcy Court was required to and did make several factual and legal determinations that were not "disposed of in passing on objections" to Pierce's proof of claim for defamation, which the court had denied almost a year earlier. There was some overlap between Vickie's counterclaim and Pierce's defamation claim that led the courts below to conclude that the counterclaim was compulsory, or at least in an "attenuated" sense related to Pierce's claim. But there was never any reason to believe that the process of adjudicating Pierce's proof of claim would necessarily resolve Vickie's counterclaim.

In both *Katchen* and *Langenkamp,* moreover, the trustee bringing the preference action was asserting a right of recovery created by federal bankruptcy law. Vickie's claim, in contrast, is in no way derived from or dependent upon bankruptcy law; it is a state tort action that exists without regard to any bankruptcy proceeding.

Vickie additionally argues that the Bankruptcy Court's final judgment was constitutional because bankruptcy courts under the 1984 Act are properly deemed "adjuncts" of the district courts. We rejected a similar argument in *Northern Pipeline,* and our reasoning there holds true today.

To begin, as explained above, it is still the bankruptcy court itself that exercises the essential attributes of judicial power over a matter such as Vickie's counterclaim. The new bankruptcy courts, like the old, do not "ma[k]e only specialized, narrowly confined factual determinations regarding a particularized area of law" or engage in "statutorily channeled fact-finding functions." Instead, bankruptcy courts under the 1984 Act resolve "[a]ll matters of fact and law in whatever domains of the law to which" the parties' counterclaims might lead.

In addition, a bankruptcy court resolving a counterclaim under 28 U.S.C. § 157(b)(2)(C) has the power to enter "appropriate orders and judgments"—including final judgments—subject to review only if a party chooses to appeal. It is thus no less the case here than it was in *Northern Pipeline* that "[t]he authority—and the responsibility—to make an informed, final determination ... remains with" the bankruptcy judge, not the district court. Given that authority, a bankruptcy court can no more be deemed a mere "adjunct" of the district court than a district court can be deemed such an "adjunct" of the court of appeals. We certainly cannot accept the dissent's notion that judges who have the power to enter final, binding orders are the "functional" equivalent of "law clerks and the Judiciary's administrative officials." And even were we wrong in this regard, that would only confirm that such judges should not be in the business of entering final judgments in the first place.

It does not affect our analysis that, as Vickie notes, bankruptcy judges under the current Act are appointed by the Article III courts, rather than the President. If—as we have concluded—the bankruptcy court itself exercises "the essential attributes of judicial power [that] are reserved

to Article III courts," it does not matter who appointed the bankruptcy judge or authorized the judge to render final judgments in such proceedings. The constitutional bar remains.

Finally, Vickie and her *amici* predict as a practical matter that restrictions on a bankruptcy court's ability to hear and finally resolve compulsory counterclaims will create significant delays and impose additional costs on the bankruptcy process. It goes without saying that "the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution."

In addition, we are not convinced that the practical consequences of such limitations on the authority of bankruptcy courts to enter final judgments are as significant as Vickie and the dissent suggest. The dissent asserts that it is important that counterclaims such as Vickie's be resolved "in a bankruptcy court," and that, "to be effective, a single tribunal must have broad authority to restructure [debtor-creditor] relations." But the framework Congress adopted in the 1984 Act already contemplates that certain state law matters in bankruptcy cases will be resolved by judges other than those of the bankruptcy courts. 1334(c)(2), for example, requires that bankruptcy courts abstain from hearing specified non-core, state law claims that "can be timely adjudicated[] in a State forum of appropriate jurisdiction." Section 1334(c)(1) similarly provides that bankruptcy courts may abstain from hearing any proceeding, including core matters, "in the interest of comity with State courts or respect for State law."

As described above, the current bankruptcy system also requires the district court to review *de novo* and enter final judgment on any matters that are "related to" the bankruptcy proceedings, § 157(c)(1), and permits the district court to withdraw from the bankruptcy court any referred case, proceeding, or part thereof, § 157(d). Pierce has not argued that the bankruptcy courts "are barred from `hearing' all counterclaims" or proposing findings of fact and conclusions of law on those matters, but rather that it must be the district court that "finally decide[s]" them. We do not think the removal of counterclaims such as Vickie's from core bankruptcy jurisdiction meaningfully changes the division of labor in the current statute; we agree with the United States that the question presented here is a "narrow" one.

If our decision today does not change all that much, then why the fuss? Is there really a threat to the separation of powers where Congress has conferred the judicial power outside Article III only over certain counterclaims in bankruptcy? The short but emphatic answer is yes. A statute may no more lawfully chip away at the authority of the Judicial Branch than it may eliminate it entirely. "Slight encroachments create new boundaries from which legions of power can seek new territory to capture." Although "[i]t may be that it is the obnoxious thing in its mildest and least repulsive form," we cannot overlook the intrusion: "illegitimate and unconstitutional practices get their first footing in that way, namely, by silent approaches and slight deviations from legal modes of procedure." We cannot compromise the integrity of the system of separated powers and the role of the Judiciary in that system, even with respect to challenges that may seem innocuous at first blush.

Article III of the Constitution provides that the judicial power of the United States may be vested only in courts whose judges enjoy the protections set forth in that Article. We conclude today that Congress, in one isolated respect, exceeded that limitation in the Bankruptcy Act of 1984. The Bankruptcy Court below lacked the constitutional authority to enter a final judgment on

a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim. Accordingly, the judgment of the Court of Appeals is affirmed.

It is so ordered.

3.6.2. WELLNESS INTERNATIONAL NETWORK, LTD., v. SHARF, 135 S.Ct. 1932 (2015)

JUSTICE SOTOMAYOR delivered the opinion of the Court.

Article III, §1, of the Constitution provides that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." Congress has in turn established 94 District Courts and 13 Courts of Appeals, composed of judges who enjoy the protections of Article III: life tenure and pay that cannot be diminished. Because these protections help to ensure the integrity and independence of the Judiciary, "we have long recognized that, in general, Congress may not withdraw from" the Article III courts "any matter which, from its nature, is the subject of a suit at the common law, or in equity, or in admiralty." *Stern v. Marshall*

Congress has also authorized the appointment of bankruptcy and magistrate judges, who do not enjoy the protections of Article III, to assist Article III courts in their work. The number of magistrate and bankruptcy judgeships exceeds the number of circuit and district judges. And it is no exaggeration to say that without the distinguished service of these judicial colleagues, the work of the federal court system would grind nearly to a halt.

Congress' efforts to align the responsibilities of nonArticle III judges with the boundaries set by the Constitution have not always been successful. In *Northern Pipeline* and more recently in *Stern*, this Court held that Congress violated Article III by authorizing bankruptcy judges to decide certain claims for which litigants are constitutionally entitled to an Article III adjudication.

This case presents the question whether Article III allows bankruptcy judges to adjudicate such claims with the parties' consent. We hold that Article III is not violated when the parties knowingly and voluntarily consent to adjudication by a bankruptcy judge.

> [Omitted is the Court's discussion of jurisdiction through the statutory revisions made in 28 U.S.C. § 157 after *Marathon*.]

Absent consent, bankruptcy courts in non-core proceedings may only "submit proposed findings of fact and conclusions of law," which the district courts review de novo. § 157(c)(1).

Petitioner Wellness International Network is a manufacturer of health and nutrition products. Wellness and respondent Sharif entered into a contract under which Sharif would distribute Wellness' products. The relationship quickly soured, and in 2005, Sharif sued Wellness in the United States District Court for the Northern District of Texas. Sharif repeatedly ignored Wellness' discovery requests and other litigation obligations, resulting in an entry of default judgment for Wellness. The District Court eventually sanctioned Sharif by awarding Wellness over $650,000 in attorney's fees. This case arises from Wellness' long-running—and so far unsuccessful—efforts to collect on that judgment.

In February 2009, Sharif filed for Chapter 7 bankruptcy in the Northern District of Illinois. The bankruptcy petition listed Wellness as a creditor. Wellness requested documents concerning Sharif 's assets, which Sharif did not provide. Wellness later obtained a loan application Sharif had filed in 2002, listing more than $5 million in assets. When confronted, Sharif informed Wellness and the Chapter 7 trustee that he had lied on the loan application. The listed assets, Sharif claimed, were actually owned by the Soad Wattar Living Trust (Trust), an entity Sharif said he administered on behalf of his mother, and for the benefit of his sister. Wellness pressed Sharif for information on the Trust, but Sharif again failed to respond. Wellness filed a five-count adversary complaint against Sharif in the Bankruptcy Court. Counts I–IV of the complaint objected to the discharge of Sharif's debts because, among other reasons, Sharif had concealed property by claiming that it was owned by the Trust. Count V of the complaint sought a declaratory judgment that the Trust was Sharif's alter ego and that its assets should therefore be treated as part of Sharif's bankruptcy estate.

In his answer, Sharif admitted that the adversary proceeding was a "core proceeding" under 28 U.S.C. §157(b)—i.e., a proceeding in which the Bankruptcy Court could enter final judgment subject to appeal. Indeed, Sharif requested judgment in his favor on all counts of Wellness' complaint and urged the Bankruptcy Court to "find that the Soad Wattar Living Trust is not property of the [bankruptcy] estate." A familiar pattern of discovery evasion ensued. Wellness responded by filing a motion for sanctions, or, in the alternative, to compel discovery. Granting the motion to compel, the Bankruptcy Court warned Sharif that if he did not respond to Wellness' discovery requests a default judgment would be entered against him. Sharif eventually complied with some discovery obligations, but did not produce any documents related to the Trust. In July 2010, the Bankruptcy Court issued a ruling finding that Sharif had violated the court's discovery order. It accordingly denied Sharif's request to discharge his debts and entered a default judgment against him in the adversary proceeding. And it declared, as requested by count V of Wellness' complaint, that the assets supposedly held by the Trust were in fact property of Sharif's bankruptcy estate because Sharif "treats [the Trust's] assets as his own property." Sharif appealed to the District Court.

Six weeks before Sharif filed his opening brief in the District Court, this Court decided *Stern*. In *Stern*, the Court held that Article III prevents bankruptcy courts from entering final judgment on claims that seek only to "augment" the bankruptcy estate and would otherwise "exis[t] without regard to any bankruptcy proceeding." Sharif did not cite *Stern* in his opening brief. Rather, after the close of briefing, Sharif moved for leave to file a supplemental brief, arguing that in light of *In re Ortiz*, 665 F.3d 906 (CA7 2011)—a recently issued decision interpreting Stern—"the bankruptcy court's order should only be treated as a report and recommendation." The District Court denied Sharif's motion for supplemental briefing as untimely and affirmed the Bankruptcy Court's judgment.

[The Court then reviewed the lower courts opinions, including the Seventh Circuit's conclusion that Wellness's claims were "*Stern*" claims – designated by 28 U.S.C. § 157 as core claims but not constitutionally subject to core jurisdiction – and that Stern could not consent to the Bankruptcy Court's jurisdiction because separation of powers considerations were implicated.] We . . . now reverse the judgment of the Seventh Circuit.

Our precedents make clear that litigants may validly consent to adjudication by bankruptcy courts. Adjudication by consent is nothing new. Indeed, "[d]uring the early years of the Republic,

federal courts, with the consent of the litigants, regularly referred adjudication of entire disputes to non-Article III referees, masters, or arbitrators, for entry of final judgment in accordance with the referee's report." The foundational case in the modern era is *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833 (1986). . . . [In Schor, the Court] explained why this waiver legitimated the [parties'] exercise of authority: "[A]s a personal right, Article III's guarantee of an impartial and independent federal adjudication is subject to waiver, just as are other personal constitutional rights"—such as the right to a jury— "that dictate the procedures by which civil and criminal matters must be tried." The Court went on to state that a litigant's waiver of his "personal right" to an Article III court is not always dispositive because Article III "not only preserves to litigants their interest in an impartial and independent federal adjudication of claims . . . , but also serves as 'an inseparable element of the constitutional system of checks and balances.' . . . To the extent that this structural principle is implicated in a given case"—but only to that extent— "the parties cannot by consent cure the constitutional difficulty . . . ." Leaning heavily on the importance of Schor's consent, the Court found no structural concern implicated by the . . . adjudication of the counterclaims against him.

While "Congress gave the CFTC the authority to adjudicate such matters," the Court wrote "the decision to invoke this forum is left entirely to the parties and the power of the federal judiciary to take jurisdiction of these matters is unaffected. In such circumstances, separation of powers concerns are diminished, for it seems self-evident that just as Congress may encourage parties to settle a dispute out of court or resort to arbitration without impermissible incursions on the separation of powers, Congress may make available a quasi-judicial mechanism through which willing parties may, at their option, elect to resolve their differences." The option for parties to submit their disputes to a nonArticle III adjudicator was at most a "de minimis" infringement on the prerogative of the federal courts. [The Court also discussed two cases under the Federal Magistrates Act, *Gomez v. United States*, 490 U.S. 858 (1989), and *Peretz v. United States*, 501 U.S. 923 (1991) "that reiterated the importance of consent to the constitutional analysis.] The lesson of *Schor*, *Peretz*, and the history that preceded them is plain: The entitlement to an Article III adjudicator is "a personal right" and thus ordinarily "subject to waiver,"

Article III also serves a structural purpose, "barring congressional attempts 'to transfer jurisdiction [to non-Article III tribunals] for the purpose of emasculating' constitutional courts and thereby prevent[ing] 'the encroachment or aggrandizement of one branch at the expense of the other.'" But allowing Article I adjudicators to decide claims submitted to them by consent does not offend the separation of powers so long as Article III courts retain supervisory authority over the process.

The question here, then, is whether allowing bankruptcy courts to decide *Stern* claims by consent would "impermissibly threate[n] the institutional integrity of the Judicial Branch." And that question must be decided not by "formalistic and unbending rules," but "with an eye to the practical effect that the" practice "will have on the constitutionally assigned role of the federal judiciary." The Court must weigh "the extent to which the essential attributes of judicial power are reserved to Article III courts, and, conversely, the extent to which the non-Article III forum exercises the range of jurisdiction and powers normally vested only in Article III courts, the origins and importance of the right to be adjudicated, and the concerns that drove Congress to depart from the requirements of Article III." Applying these factors, we conclude that allowing bankruptcy litigants to waive the right to Article III adjudication of *Stern* claims does not usurp the

constitutional prerogatives of Article III courts. [the Court then reviews the pervasive power of control exercised by the District Courts over the Bankruptcy Court's jurisdiction under 28 U.S.C. § 157].

Our recent decision in *Stern*, on which Sharif and the principal dissent rely heavily, does not compel a different result. That is because *Stern*—like its predecessor, *Northern Pipeline*—turned on the fact that the litigant "did not truly consent to" resolution of the claim against it in a non-Article III forum. [The Court distinguishes these prior cases as not involving true consent, and responds various arguments made by the dissent].

Sharif contends that to the extent litigants may validly consent to adjudication by a bankruptcy court, such consent must be express. We disagree. Nothing in the Constitution requires that consent to adjudication by a bankruptcy court be express. Nor does the relevant statute, 28 U.S.C. §157, mandate express consent; it states only that a bankruptcy court must obtain "the consent"—consent simpliciter—"of all parties to the proceeding" before hearing and determining a non-core claim. § 157(c)(2). . . . It bears emphasizing, however, that a litigant's consent—whether express or implied—must still be knowing and voluntary. . . . [T]he key inquiry is whether "the litigant or counsel was made aware of the need for consent and the right to refuse it, and still voluntarily appeared to try the case" before the non-Article III adjudicator. [1]

It would be possible to resolve this case by determining whether Sharif in fact consented to the Bankruptcy Court's adjudication. . . . But reaching that determination would require a deeply fact bound analysis of the procedural history unique to this protracted litigation. Our resolution of the consent question—unlike the antecedent constitutional question—would provide little guidance to litigants or the lower courts. Thus, consistent with our role as "a court of review, not of first view," we leave it to the Seventh Circuit to decide on remand whether Sharif 's actions evinced the requisite knowing and voluntary consent, and also whether, as Wellness contends, Sharif forfeited his *Stern* argument below.

The Court holds that Article III permits bankruptcy courts to decide Stern claims submitted to them by consent. The judgment of the United States Court of Appeals for the Seventh Circuit is therefore reversed, and the case is remanded for further proceedings consistent with this opinion.

3.7. Practice Problems: Bankruptcy Court Jurisdiction

Problem 1. Creditor files a proof of claim against the estate. Is a counterclaim brought against the creditor under Section 548 of the Bankruptcy Code to recover a fraudulent conveyance

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[1] FOOTNOTE 13 Even though the Constitution does not require that consent be express, it is good practice for courts to seek express statements of consent or nonconsent, both to ensure irrefutably that any waiver of the right to Article III adjudication is knowing and voluntary and to limit subsequent litigation over the consent issue. Statutes or judicial rules may require express consent where the Constitution does not. Indeed, the Federal Rules of Bankruptcy Procedure already require that pleadings in adversary proceedings before a bankruptcy court "contain a statement that the proceeding is core or non-core and, if non-core, that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy judge." Fed. Rule Bkrtcy. Proc. 7008. The Bankruptcy Court and the parties followed that procedure in this case.

a "core" matter under Section 157? *See* 28 U.S.C. § 157(b)(2)(C). If so, is it constitutional for the claim to be a "core" matter?

Problem 2. If the creditor in the previous problem did not file a proof of claim, would *Stern v. Marshall* apply – would it be a "core" matter under the statute, but unconstitutional to treat it as a "core" matter? If so, can the bankruptcy court hear the claim at all, and if so how would the bankruptcy court's decision be treated? *See* *Exec. Benefits Ins. Agency v. Arkison*, 134 S.Ct. 2165 (2014).

Problem 3. Is 28 U.S.C. § 157(b)(2)(O) constitutional? Can you think of any legal matters that might arise in a bankruptcy case that would not affect the debtor-creditor or equity security holder relationship?

Problem 4. Suppose a creditor who was injured by the debtor's defective product files a proof of claim in the bankruptcy proceeding. The debtor then files an objection to the claim. Who will determine the merits of the claim? *See* 28 U.S.C. § 157(b)(5). Does the creditor need to do anything if the creditor does not want the matter to be heard by the bankruptcy court? *See* Bankruptcy Rule 5011. Can the Bankruptcy Court estimate the claim for purposes of determining the size of the creditor's vote on confirmation of a plan of reorganization? Read 28 U.S.C. § 157(b)(2)(B) carefully.

Problem 5. Suppose that prior to the debtor filing bankruptcy in the previous problem, the creditor had brought a claim in state court against the debtor that was about to go to trial. As we will see, the debtor's bankruptcy filing prevents the creditor from proceeding with the state court lawsuit. Can the creditor do anything to return jurisdiction over the amount of the claim to the state court. *See* 28 U.S.C. § 1334(c)(1) and (2).

Problem 6. What is the "de novo" review required by 28 U.S.C. § 157(c)(1)? *See* Bankruptcy Rule 9033(d). When is withdrawal of reference mandatory under 28 U.S.C. § 157(d)?

3.8. Venue of Bankruptcy Cases

In which bankruptcy court should the debtor file his, her or its case? With respect to consumer debtors the test looks at which judicial district the debtor has lived in the **longest** during the 180 day period prior to bankruptcy. 28 U.S.C. § 1408(1). You have to count days in each jurisdiction if the debtor has moved during the 180 day period before the bankruptcy is filed.

The statute is not so clear for entities or individuals with significant business assets. The statute focuses on where the debtor has been domiciled or resided the most during the 180 day period, but also where the debtor's "principal place of business or principal assets" have been located. This would, in essence, allow a Delaware corporation, with a principal place of business in New York and principal assets in Wyoming to forum shop.

An even greater forum shopping loophole is contained in 28 U.S.C. § 1408(2), which through simple planning allows entities even greater leeway to forum shop. This section allows an entity to file bankruptcy wherever a subsidiary has filed. One would think, however, that the court would be duty bound to transfer the case to the most proper and convenient forum if the debtor abused the venue rules by engaging in forum shopping. 28 U.S.C. § 1412 provides for transfer on

"forum non-conveniens" grounds. But as the famous case of Enron Corporation printed below demonstrates, courts have been extremely proprietary in exercising their discretion to transfer cases to a more convenient forum.

There has been much criticism of the broad venue shopping rules, which many believe has corrupted the bankruptcy system by allowing corporations to choose management friendly locals for their bankruptcy filings. Indeed, many believe that the courts in Delaware and New York City have competed for Chapter 11 cases by issuing increasingly management friendly rulings. The following decision, involving one of the largest bankruptcy cases ever filed by the most Texan of companies, does nothing to dispel these criticisms.

3.9. Cases on Bankruptcy Venue

3.9.1. IN RE ENRON CORP., 274 B.R. 327 (2002)

ARTHUR J. GONZALEZ, Bankruptcy Judge.

The issue before the Court is whether venue of these bankruptcy cases should be transferred from the Southern District of New York to the Southern District of Texas.

Enron is a large, multifaceted national and international corporation with operations, financial interests, creditors and stockholders across the United States and around the world. Enron maintained the world's largest online energy trading site and was the world's largest trader of electricity and natural gas.

None of the Debtors own real property located in New York. With the exceptions of Garden State Paper Company, LLC, EMC and Operational Energy Corp., all of the Debtors have identified their principal place of business as being Houston, Texas.

All or substantially all of certain of the Debtors' corporate books and records (such as corporate minute books) are located at the corporate headquarters of Enron Corp. in Houston.

Approximately fifty-five current or former officers of Enron Corp. reside in Houston, Texas or in the Southern District of Texas. Most of these inside directors reside in Houston, Texas or elsewhere in the Southern District of Texas.

[The Court reviews Enron's bank loans, noting that the loans were administered in the Bank's Houston offices, although the Banks' main offices were in New York.]

As of December 2, 2001, the bankruptcy petition date, Enron Corp. and its affiliates employed approximately 25,000 full and part time employees worldwide. Of these employees of the Debtors, 4,681 worked in Houston, and sixty-three of these employees of the Debtors worked in New York.

On November 30, 2001, Enron Corp. and/or its affiliates paid $55 million in bonuses to 587 of its "key employees." The vast majority of these key employees are located in Houston.

Most of the Debtors' real property is located in Houston. Subsidiaries of the Debtor, Enron Corp., own interstate pipelines. The amount of ad valorem taxes owed to Texas taxing authorities by Enron is $139,878,630.

ENRON METALS & COMMODITY CORP.

EMC is a Delaware corporation with its principal place of business in New York, New York. EMC is engaged primarily in the business of commodities metals trading.

Using the asset values assigned by the Debtors on the date of filing, Enron Metals' assets ($265,622,903) are less than 0.5% of the assets of the consolidated Debtors ($51,523,148,911). EMC has approximately fifty-five employees working in New York, New York. EMC has three employees in St. Louis, five in Chicago and none in Texas.

AFFILIATED DEBTORS (INCLUDING ENRON CORP.)

Of the twenty-eight affiliated debtors, including Enron Corp., twenty-six have their principal place of business located in Houston. For most of the affiliated debtors, including Enron Corp., the location of the principal assets and the location of the corporate books and records is also in Houston. Nearly all of the executives and officers reside in Houston.

THE DEBTORS' PROFESSIONALS

[The Debtor's law firms have their main offices in

New York, but also substantial offices in Houston]

Prior to their bankruptcy, the Debtors employed 145 lawyers in their Houston offices.

FOREIGN INSOLVENCY PROCEEDINGS

A number of Enron affiliates are in insolvency, bankruptcy or administration proceedings worldwide.

ACCESSIBILITY OF NEW YORK

New York is one of the world's most accessible locations. New York is served by three airports with international flights, as well as major rail stations making it accessible to parties in interest located worldwide. It is convenient with respect to both the diversity of locations served and the frequency of service provided.

New York is located over 1,600 miles from Enron's corporate headquarters in Houston which is located a few blocks from the United States Bankruptcy Court for the Southern District of Texas. A roundtrip flight from Houston to New York takes approximately seven hours. The average price of a roundtrip ticket from Houston to New York, full coach fare, is $1,807.85. No flights departing from Houston, Texas arrive in New York prior to 10:00 a.m. Eastern Time.

REORGANIZATION PROCEEDINGS

There are six principal employees of the Debtors who are expected to be responsible for the financial restructuring and development of a plan of reorganization, and they are based in Houston.

DISCUSSION

Section 1408 of title 28 of the United States Code governs venue in Chapter 11 cases. 28 U.S.C. § 1408 provides . . . . Under § 1408(1), a prospective debtor may select the venue for its Chapter 11 reorganization. Specifically, venue is proper in any jurisdiction where the debtor maintains a domicile, residence, principal place of business or where its principal assets are located

for at least 180 days before the filing of the bankruptcy petition. Pursuant to 28 U.S.C. § 1408(2), venue is also proper for any affiliate that files a bankruptcy petition within a venue where there is already a bankruptcy case pending under § 1408(1).

Applied here, EMC filed a petition under the Bankruptcy Code on December 2, 2001 For purposes of venue under 28 U.S.C. 1408(1), the Court finds that EMC's bankruptcy petition was properly venued in the Southern District of New York because EMC maintains its principal place of business within this district.

Enron Corp. is the holding company that directly or indirectly owns all the other Debtors. Immediately after EMC's case was filed in this Court, Enron Corp., as an affiliate of EMC, filed its petition under the Bankruptcy Code on December 2, 2001 and was assigned case number 01-16034. Its selection of this venue was proper under 28 U.S.C. § 1408(2).

When venue is determined to be proper in the district where the bankruptcy case was filed, the case may nevertheless be transferred, on motion by a party, pursuant to 28 U.S.C. § 1412. A motion to transfer venue is a core matter, as it concerns administration of the estate. The burden is on the movant to show by a preponderance of the evidence that the transfer of venue is warranted. The decision of whether to transfer venue is within the court's discretion based on an individualized case-by-case analysis of convenience and fairness. A debtor's choice of forum is entitled to great weight if venue is proper.

Pursuant to 28 U.S.C. § 1412, the Court must grant relief if it is established that a transfer of venue would be proper if it is in (1) the interest of justice or (2) the convenience of the parties. In considering the convenience of the parties, the Court weighs a number of factors: [proximity of debtor, creditors, witnesses, location of assets, economic administration of estate]. The factor given the most weight is the promotion of the economic and efficient administration of the estate.

In the context of the Debtors' cases, the factors considered cannot be viewed in an insular manner. Rather, the standards must be applied with a broader perspective, taking into account the national and international scope of the Debtors' businesses as well as the geographical dispersal of the creditors involved. Moreover, the standards must be applied considering the realities of the administration of a complex chapter 11 debtor seeking to reorganize.

Although the business relationship between the Debtors and the creditors may have been initiated from a desk in Houston, its impact is far reaching and geographically diverse.

With respect to accessibility of this Court to all parties-in-interest, the dockets of all of the cases pending before the Southern District of New York are currently available on the internet at the Court's web-site by obtaining a PACER password. The electronic filing system allows those with an interest to have access to all pleadings filed in any case.

The location of the assets is not as important where the ultimate goal is rehabilitation rather than liquidation. Although the Debtors are seeking to sell a portion of their assets to facilitate their financial restructuring, this is not a Chapter 7 liquidation. Furthermore, while a debtor's location and the location of its assets are often important considerations in single asset real estate cases, these factors take on less importance in a case where a debtor has assets in various locations.

While the majority of the Debtor entities have their headquarters in Texas, Enron's assets are geographically located throughout the world. Aside from the office building and other tangible assets which are located in Texas, much of the Debtors' assets consist of contracts and trading

operations which have no tangible location. Furthermore, the presence of the books and records in Houston is not a major concern because with modern technology that information, which is ordinarily computerized, can be readily transported via electronic mail.

Economic and efficient administration of the estate

It is clear that the most important of these considerations is the economic and efficient administration of the estate. One must examine the realities of this case. It is the largest bankruptcy case ever filed, the complexities of which are yet to be fully appreciated. Its reorganization will depend in great part on the ability of the Debtors' advisors and senior managers to achieve a financial restructuring that will result in the capital markets regaining confidence in the Debtors, thereby affording the Debtors full and complete access to those markets.

New York is a world financial center and, as such, has the resources that will be required to address the Debtors' financial issues. Most of the entities and individuals expected to be responsible for the financial restructuring and development of a plan of reorganization in this case are located in New York or have ready access to New York, including most of the Debtors' legal and financial advisors as well as the legal and financial advisors to the Committee and the lenders. Those members of the financial community that provide access to capital necessary to the Debtors' financial restructuring are located in New York. Furthermore, while the Debtors' management and operations are predominantly in Houston, New York is a more convenient location for those responsible for negotiating and formulating a plan of reorganization. The Court finds that New York is the more economic and convenient forum for those whose participation will be required to administer these cases. Accordingly, New York is the location which would best serve the Debtors' reorganization efforts-the creation and preservation of value.

This Court has gained familiarity with many of the issues that have and will continue to arise in these cases. The Movants argue that since they timely filed their motions to transfer venue, the "learning curve" should not be considered. However, the importance of maintaining stability in these bankruptcy cases required the Court to direct its immediate attention to the proper administration of these cases. A review of the docket shows that many requests for shortened notice were filed for matters to be heard concerning a myriad of issues, including claims that supplies of energy were to be imminently discontinued. These issues had to be immediately addressed.

Maintaining the stability of these cases and ensuring their proper administration had to take precedence over the request for an expedited venue hearing. Further, as previously discussed, the learning curve that has been established in the Enron Debtors' cases contributes to judicial economy. A transfer at this time would not promote judicial economy as it would only delay pending matters while a transferee court familiarized itself with the intricacies of these cases.

The fact that New York is a financial center and the presence in New York of those who will participate on a consistent basis in these cases make New York the most efficient forum for administering these cases.

The Court finds that in considering matters of judicial economy, timeliness and fairness as well as the efficient administration of the estate, the interest of justice is served by retaining jurisdiction.

3.10. Practice Problems: Filing Voluntary Petitions

The eligibility rules for filing bankruptcy are very liberal. Review 11 U.S.C. § 109 and answer the following questions:

Problem 1. How can a corporation or partnership file bankruptcy when Section 109(a) limits filings to "persons?" *See* 11 U.S.C. § 101(41).

Problem 2. Can a business trust file bankruptcy? How about a non-business trust? 11 U.S.C. § 101(9).

Problem 3. Can a foreign citizen living in the United States file bankruptcy here? How about a foreign citizen living abroad who has a business in the United States? 11 U.S.C. § 109(a).

Problem 4. Can a railroad file under Chapter 7? How about Chapter 11? 11 U.S.C. § 109(b), (d).

Problem 5. Can a bank or insurance company file under Chapter 7 or Chapter 11? 11 U.S.C. § 109(b), (d). Can you think of a reason for this rule?

Problem 6. Only "municipalities" are eligible for Chapter 9. What is a municipality? 11 U.S.C. § 101(40). Could a state file a Chapter 9 case?

Problem 7. Chapter 12 is available only to "family farmers" and "family fisherman" with regular income. Where would we look for a definition of these terms?

Problem 8. Can a small family corporation that otherwise meets the requirements file under Chapter 13? 11 U.S.C. § 109(e).

Problem 9. Can an individual who works on commission file under Chapter 13? How about an individual who has no job but receives a monthly support payment from a relative?

Problem 10. Can a stockbroker file under Chapter 13? *See* 11 U.S.C. § 101(30).

Problem 11. Can a debtor with the following debts file under Chapter 13:

Home Mortgage: $600,000

Guaranty of Mother's Home Mortgage: $700,000

Student loan debts: $175,000

Guaranty of Son's student loan debts: $250,000

Credit card debts $50,000

Pending lawsuit filed by driver of car rear-ended by the Debtor: $1,000,000.

3.11. Voluntary Bankruptcy Petitions

An eligible debtor commences a voluntary bankruptcy case by filing the official petition form with the Bankruptcy Court and paying the required filing fee. As of the date this was written, the filing fee for a Chapter 7 case is $335.

A debtor whose income is less than 150% of the poverty guidelines may file an *in forma pauperis* request for a fee waiver. 28 U.S.C. § 130(f). Alternatively, a debtor unable to pay the fee on the petition date may request to pay the filing fee in installments. Bankruptcy Rule 1006(b). The Court will accept the petition without the fee if the debtor files with the petition a request either for a waiver of the fee or to pay the fee in installments. It is entirely within the bankruptcy judge's discretion whether to grant a fee waiver or installment request. Since there are no real legal standards for granting or denying these requests (other than the requirement to be below 150% of the poverty guidelines for a waiver), there is a wide variance throughout the country as to how receptive judges are to the requests.

Debtors are required to make extensive financial disclosures as part of the bankruptcy process. 11 U.S.C. § 521(a); Bankruptcy Rule 1007(b). Specifically, debtors must file a set of schedules on official forms listing (1) their assets (real and personal property), (2) each of their creditors (name, address, account number, and amount), (3) their current income and expenses (and any anticipated increases or decreases); (4) their executory contracts and leases, (5) a Statement of Affairs form listing much additional personal and financial information, and (6) pay stubs received from an employer during the 60 days before bankruptcy; (7) a statement of exemptions. Id. In addition, individual debtors must file (8) a certificate of completion from an approved credit counseling agency, and (9) a statement of intention with respect to leased or secured property. 11 U.S.C. § 521(b); (a)(2); Individual debtors whose debts are primarily consumer debts must file (10) a form showing compliance with the means test; (11) a certificate of completion from an approved credit counseling agency. Id.; Bankruptcy Rule 1007(a). Attorneys representing debtors must file a statement disclosing fees and certifying that certain disclosures have been made to the debtor. *See* 11 U.S.C. § 329.

The Schedules and statements are normally filed with the petition. However, in emergency situations debtors often file "bare bones" petitions which do not contain all of the required information. In that case, the Court will automatically issue an order noting the deficiencies and setting a deadline for compliance (at least if the clerk's office notices the deficiency).

Section 521(i)(1) contains an extremely draconian rule for consumer cases if the required information and forms are not filed within 45 days after the petition is filed. The section provides that the case is to be "**automatically** dismissed" effective on the 46th day. 11 U.S.C. § 521(i)(1). This rule has worked an extreme hardship on debtors who were unaware of their technical filing deficiency. The author of this book has argued in a law review article that the automatic dismissal rules as written are unconstitutional, and that notice and an opportunity for hearing is required before dismissal. Gregory Germain, *Due Process in Bankruptcy: Are the New Automatic Dismissal Rules Constitutional*, 13 U. Pa. Journal of Business Law 547 (Spring 2011). After that article was written, many Bankruptcy Courts discontinued the practice of automatic dismissals and have begun to provide notice and opportunity for hearing before dismissing bankruptcy cases.

After filing bankruptcy, debtors must send the trustee (and any creditor who requests one in writing) a copy of their most recent federal tax return (at least 7 days before the official meeting of creditors under Section 341. 11 U.S.C. § 521(e)(2).

Following the filing, the Court will send notice of the bankruptcy filing to all creditors listed in the schedules. The notice will list the date for the official meeting of creditors under

Section 341 of the Bankruptcy Code, the deadline for objecting to the debtor's discharge, the deadline for filing claims (if applicable), and other important information.

The debtor must attend the meeting of creditors under Section 341 in person, and answer questions. The trustee presides at the meeting and will ask the debtor questions about the case and the schedules. In addition, creditors are allowed to ask questions of the debtor, but the trustee will generally limit the time for questions in order to get through all of the other 341 hearings pending on the same date and time. Trustees generally require the debtor to bring original identification to verify the debtor's identity and social security number (generally a driver's license and social security card will suffice).

3.12. Involuntary Bankruptcy Petitions

Involuntary bankruptcy petitions are filed **by creditors** against the Debtor. Involuntary petitions have become very rare. With all the benefits of collective action, financial disclosure and equal treatment for creditors, why are so few involuntary petitions filed every year? To answer this question, one must understand the involuntary bankruptcy process. Read 11 U.S.C. § 303 and answer the following questions:

3.13. Practice Problems: Involuntary Petitions

Problem 1. Farmer John owes money to everyone in town, and is not paying. Can creditors join together and file an involuntary bankruptcy petition?

Problem 2. Can an involuntary bankruptcy petition be filed under Chapter 13?

Problem 3. Debtor owes Bank $200,000 secured by a mortgage on the debtor's home. Property values have fallen dramatically, and the house is worth only $120,000. Debtor has stopped making payments to the bank. You are the Bank's lawyer. The Bank asks you whether it can file an involuntary bankruptcy petition against the Debtor. What would you need to know to answer that question? *See* 11 U.S.C. §§ 303(b)(2); 303(h). How would you go about getting the information you would need to answer your client's question?

Problem 4. After reviewing the best available information you determine that the Debtor has only 9 other eligible creditors, and based on your analysis the Bank files an involuntary petition. You find out, however, that the Debtor owed money to 4 other creditors who you had no way of knowing about. What is the consequence to the Bank (and to you) of filing a one-creditor involuntary petition? *See* 11 U.S.C. § 303(i).

Problem 5. The Bank asks you what the phrase "generally not paying such debtor's debts as such debts become due" in Section 303(h) means. What do you tell them? How would you determine whether the Debtor is "generally not paying?"

Problem 6. Assume that the Bank, without consulting you, correctly determined that the Debtor had only 9 other creditors, and filed an involuntary bankruptcy petition. It turns out, however, that the Debtor only had a few other small creditors, and the debtor was paying all of his small debts on time. The Bankruptcy Court determines that the Debtor had been "generally paying"

its debts when due, even though your client was not being paid and held the large bulk of the debtor's debts. Could the Bank be held liable for damages or punitive damages for filing the involuntary petition? *See* *In re Silverman*, 230 B.R. 46 (Bankr. D. N.J. 1998) (holding creditor liable for $50,000 in punitive damages for not checking debtor's credit report to see whether debtor was "generally paying" before filing bankruptcy, and for filing involuntary on the basis of a partially disputed debt); *In re Macke International Trade, Inc.*, 370 B.R. 236 (Bankr. 9th Cir. 2007) (holding the creditor liable for $20,000 in attorney fees under Section 303(i), even though the petition was proper and dismissal was granted under Section 305(a)(1) because "the interests of creditors and the debtor would be better served by such dismissal . . . .")

Problem 7. Three creditors join together in properly filing an involuntary petition against the Debtor. Debtor immediately pays the three creditors and moves to dismiss the involuntary petition. Must the court dismiss the case?

Problem 8. Creditor owns three separate corporations: one corporation leases equipment, one services the equipment, and one sells supplies for the equipment. Debtor owes money to all three subsidiaries. Can the three subsidiaries be counted as three separate entities for filing an involuntary petition? *See* *In re Gibraltar Amusements, Ltd.*, 291 F.2d 22, 28 (2d Cir. 1961), cert. denied, 368 U.S. 925 (1961).

3.14. Dismissal of Properly Filed Bankruptcy Petitions for "Cause"

Section 707(a) of the Bankruptcy Code allows the Court to dismiss a bankruptcy case for "Cause." "Cause" is not specifically defined, although it includes a debtor's unreasonable prejudicial delay, failure to pay fees, and failure to file schedules and other information required by Section 521(a) in a timely manner. It is important to contrast dismissal "for cause" under Section 707(a), which requires notice and an opportunity for hearing, with the automatic dismissal rules in Section 521(i)(I) which offer no due process prior to dismissal.

Does "cause" exist for dismissal if the debtor has the ability to pay his, her or its debts from future earnings? The legislative history suggests that ability to pay is not a factor that should be considered by the Courts in determining "cause."

> "The section does not contemplate, however, that the ability of the debtor to repay his debts in whole or in part constitutes adequate cause for dismissal. To permit dismissal on that ground would be to enact a non-uniform mandatory chapter 13, in lieu of the remedy of bankruptcy."

H.R. Rep. No. 595, 95th Cong., 1st Sess. 380 (1977), S. Rep. No. 989, 95th Cong., 2d Sess. 94 (1978).

Most courts follow the legislative history and preclude issues of ability to pay from consideration under Section 707(a). Note that the next section of the Bankruptcy Code, Section 707(b), discussed at length below, focuses on ability to pay, although it is based on the assumption that the past is a reliable proxy for the future, which is not always true.

The courts are divided on whether prepetition bad acts can constitute "cause" for dismissal. The fundamental issue is whether a debtor must file a bankruptcy petition in "good faith" – for a proper bankruptcy purpose. Should the case be dismissed if the debtor is using bankruptcy as a litigation tactic – for example to delay a lawsuit – rather than having any legitimate and immediate need for financial relief? Outside of the consumer context most courts have said "yes." We will read one such a case shortly.

However, the Court of Appeal for the Ninth Circuit suggested that bad faith is not a factor that should be considered in 707(a) "for cause" dismissals of consumer cases. *In re Padilla*, 222 F.3d 1184 (9th Cir. 2000). The debtor in that case, Mr. Padilla, incurred over $100,000 in credit card debt shortly before bankruptcy (he claimed to have had a gambling addiction problem). The bankruptcy court granted the trustee's motion to dismiss Padilla's case for "cause" under Section 707(a), claiming he was acting in bad faith and abusing the Bankruptcy Code by incurring large amounts of credit card debt in anticipation of filing bankruptcy and receiving a discharge (a process known as a "bust out" scheme). The Court of Appeals held that bad faith conduct should not be a factor in determining "cause" for dismissal under Section 707(a). Rather, such conduct could be considered under Section 707(b), which at the time allowed dismissal of consumer cases for "substantial abuse." As we will see, the theory that bad faith in consumer cases should only be considered under Section 707(b) creates structural problems after Congress adopted the Means Test in Section 707(b).

3.15. Bad Faith Dismissals after the 2005 Amendments

With the 2005 BAPCPA amendments, Congress added Section 707(b)(3), clarifying that the Bankruptcy Court should consider both the totality of circumstances and whether the debtor filed the petition in bad faith in deciding whether to dismiss a consumer case for general "abuse" under Section 707(b). The general "abuse" test in Section 707(b) **only applies to consumer debtors**. Furthermore, as is discussed below, only the judge or the United States Trustee has standing to seek dismissal for general "abuse" if the means test is satisfied. 11 U.S.C. §§ 707(b)(1), 707(b)(6). Because of this limitation, most creditors will be unable to seek the dismissal of consumer cases filed in bad faith. The interplay of the means test and the "abuse" test appears to have undermined Congress's goal of cutting down on abusive bankruptcy filings.

What about bad faith petitions in non-consumer cases? Did Congress eliminate consideration of bad faith in the "Cause" test for businesses under Section 707(a) by including bad faith in the definition of "abuse" under Section 707(b) (which only applies to consumer cases)? Some make this argument, but I doubt that was Congress's intent. Indeed, Congress may not have even considered the effect of an amendment to Section 707(b) on an entirely unrelated section 707(a).

The cases are split on whether bad faith can be considered in non-consumer dismissals for "cause" under Section 707(a). *See* *In re Adolph*, 441 B.R. 909 (Bankr. N.D. Ill. 2011) (bad faith not a factor under Section 707(a) after 2005 BAPCPA amendments); *In re Perlin*, 497 F.3d 364, 369-70 (3d Cir. 2007) (bad faith continues to be a factor in non-consumer dismissals under Section 707(a)).

The *Padilla* panel's argument that "cause" can have different meanings under different chapters, allowing dismissal of Chapter 11 business filings for "cause," but not allowing dismissal of consumer filings for "cause," is troubling. A better approach would be to focus on whether the conduct constituting bad faith is an abuse of the bankruptcy process, in which case "cause" should exist for dismissal under any chapter. The elastic approach to "cause" utilized in the *Johns Manville* decision reprinted below strikes me as a far better approach to the problem than *Padilla's* suggestion that bad faith conduct cannot be considered in determining whether "cause" exists for dismissal in consumer cases. In using a broad term like "cause," Congress must have intended to give the courts the power to determine whether a case constitutes an abuse of the bankruptcy process and should be dismissed.

3.16. Dismissal of Cases Properly Filed under Other Chapters

The chapter proceedings contain similar broad "for cause" language for dismissal. *See* 11 U.S.C. § 1112(b)(1), 1208(c) and 1307(c). Unlike Chapter 7, however, the reorganization chapters also require the debtor to affirmatively show that the plan of reorganization has been proposed in "good faith" in order to obtain confirmation of the plan. *See* 11 U.S.C. §§ 1129(a)(3), 1225(a)(3), 1325(a)(3). Because bad faith would preclude plan confirmation, and something has to be done with a case that cannot be confirmed, one could certainly argue that the concept "bad faith" must be "cause" for dismissal. On the other hand, filing a petition in bad faith may be different from proposing a plan in bad faith, since the bad faith inquiry focuses on a different act taking place at a different point in time. The cases that follow struggle with the relationship between "cause" and "good/bad faith in seeking bankruptcy relief."

3.17. Cases on Bad Faith Dismissals

3.17.1. IN RE JOHNS-MANVILLE CORPORATION, 36 B.R. 727 (Bankr. S.D.N.Y. 1984)

Whether an industrial enterprise in the United States is highly successful is often gauged by its "membership" in what has come to be known as the "Fortune 500." Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as "Manville") were deemed a paradigm of success in corporate America by the financial community. Thus, Manville's filing for protection under Chapter 11 on August 26, 1982 was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20-30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the

asbestos-related diseases until sometime during this future period ("the future asbestos claimants"). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry's general disavowal of liability to Manville on policies written for this very purpose. Indeed, the issue of coverage has been pending for years before a state court in California. It is the propriety of the filing by Manville which is the subject of the instant decision.

Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court. Manville has opposed all four dismissal motions and has been joined in opposition to them by the Unofficial Committee of School Creditors, the Equity Holders Committee [and] . . . the Unsecured Creditors Committee. . . .

The Asbestos Committee, which is comprised with one exception of attorneys for asbestos victims, initially moved to dismiss this case on November 8, 1982 citing Manville's alleged lack of good faith in filing this petition. However, the Asbestos Committee did not press its motion before the Court until now, more than one year later. In the interim, while engaging in plan formulation negotiations, it has vigorously pursued discovery in order to bolster its factual contention that Manville knowingly perpetrated a fraud on this Court and on all its creditors and equity holders in exaggerating the profundity of its economic distress in 1981 so as to enable it to file for reorganization in 1982. Thus, the Asbestos Committee submitted in November 1983 a multitude of volumes of materials consisting of 55 days of depositions of Manville officers in alleged support of the inference that in 1981 a small Manville group "concocted" evidence to meet the requirements for filing a Chapter 11 petition. The Asbestos Committee alleges that this group manufactured evidence of crushing economic distress so as to demonstrate falsely that pursuant to required principles of accounting . . . Manville had to book a reserve of at least $1.9 billion for asbestos health liability, and thus had no alternative but to seek Chapter 11 protection. The booking of such a reserve would, in turn, have triggered the acceleration of approximately $450 million of outstanding debt, possibly resulting in a forced liquidation of key business segments. Thus, the multitudinous submissions by the Asbestos Committee are aimed at showing their challenge to the motive, methods and data used by Manville's accounting consultants, its management and its Litigation Advisory Group in determining whether relief under Chapter 11 should be sought.

Mindful that there is no insolvency requirement for Chapter 11 debtor status, the issue presented for determination by this Court is whether these allegations of error by the Asbestos Committee, even egregious error, in over-calculation of Manville's financial problems are relevant to establish the kind of bad faith in the sense of an abuse of this Court's jurisdiction which will vitiate the filing of a Chapter 11 petition. This opinion will thus elucidate whether the tomes of material submitted by the Asbestos Committee defeat the essential fact that as of August 26, 1982 Manville is a real company with real debt, real creditors and a compelling need to reorganize in order to meet these obligations.

The motions to dismiss Manville's petition . . . must be denied. Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Section 109 of the Code contains its eligibility requirements . . . .

Clearly, Manville meets the requirements contained in subsection (a) for debtors under all chapters of the Code in that it is domiciled and has its place of business in the United States. Also,

the word "person" used in subsection (a), as defined in Code section 101(30), includes an individual, a partnership, and a corporation, but not a governmental unit.

In addition, Manville meets the eligibility requirements contained in subsection (b) and made applicable to Chapter 11 debtors by subsection (d). Manville is obviously not any of the prohibited entities described in subsection (b). . . . Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement. . . . Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code. This Court will now turn to the issue of whether any of the movants have demonstrated sufficient "cause" pursuant to Code Section 1112(b) to warrant the dismissal of Manville's petition.

Section 1112(b) of the Code provides for conversion or dismissal of a case for "cause". . . . What constitutes cause under section 1112(b) is subject to judicial discretion under the circumstances of each case." [M]uch of the argument in support of all of the motions to dismiss is pitched to the confirmability of Manville's proposed plan. This argument is misplaced. Under the statutory reorganization scheme, there can be many plans advanced by many interests. Also, the concept of perpetual debtor-in-possession is not unlimited, nor is the possibility of liquidation or other forms of asset management beyond speculation. The essential determination here is the propriety of the filing, and whether "cause" exists to vitiate it, not the confirmability of a particular plan. If Manville is unable to effectuate a particular plan that is not tantamount to finding that no plan can be effectuated.

The Asbestos Committee premises its motion to dismiss the petition on what it contends is Manville's "bad faith" in filing for protection under Chapter 11. "The Asbestos Committee is prepared to prove that Manville's Chapter 11 petition is purely a bad faith maneuver by Manville to curtail its liabilities. . . ." And, in its papers in support of that motion to dismiss, the Asbestos Committee states: "These Chapter 11 cases were filed in bad faith, are an abuse of the provisions of Chapter 11 and an imposition on this Court's jurisdiction and should therefore be dismissed without further delay".

Because the allegations of the Asbestos Committee are not supported by concrete facts and thus do not rebut the essential fact that Manville is a real company with a substantial amount of real debt and real creditors clamoring to enforce this real debt, the Asbestos Committee has not sustained its burden of demonstrating sufficient fraud to vitiate the filing ab initio. [T]these petitions were filed only after Manville undertook lengthy, careful and detailed analysis. . . . According to Manville, the results of the studies by ERI and SERC corroborated each other's projections of runaway asbestos health costs within the foreseeable future.

In addition, the Compendium cites to testimony of Manville officers which details the slow and deliberate process of data commissioning and review and "soul-searching" antedating the filing, including the employment and review of results of studies. . . . The data submitted by Manville also supports the accepted inference that the $1.9 billion projected debt figure ratified by Manville was the result of careful, conservative and perhaps understated projections.

In so doing, Manville has succeeded in rebutting . . . the Asbestos Committee's allegations of fraud regarding the size of its projected debt . . . . Manville was advised by Robert O.F. Bixby of the Price Waterhouse accounting firm that it was necessary to book a $1.9 billion reserve for contingent liability according to the accrual principle in FASB-5. On balance, Manville's decision

to follow this advice was neither unreasonable, illogical, nor in any sense fraudulent. Therefore, on balance, the Asbestos Committee has failed to sustain its burden of proof of fraud as to either the magnitude of the reserve to be booked or the necessity of so booking this reserve.

In determining whether to dismiss under Code Section 1112(b), a court is not necessarily required to consider whether the debtor has filed in "good faith" because that is not a specified predicate under the Code for filing. Rather, according to Code Section 1129(a)(3), good faith emerges as a requirement for the confirmation of a plan. The filing of a Chapter 11 case creates an estate for the benefit of all creditors and equity holders of the debtor wherein all constituencies may voice their interests and bargain for their best possible treatment. . . . It is thus logical that the good faith of the debtor be deemed a predicate primarily for emergence out of a Chapter 11 case. It is after confirmation of a concrete and immutable reorganization plan that creditors are foreclosed from advancing their distinct and parochial interests in the debtor's estate.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The "Congressional purpose" in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because "assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap." Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity.

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants.

Manville's purported motivation in filing to obtain a breathing spell from asbestos litigation should not conclusively establish its lack of intent to rehabilitate and justify the dismissal of its petition. On the contrary, there has been submitted no evidence that Manville has not bargained to obtain a reorganization plan in good faith.

It is this Court's belief that there is no strict and absolute "good faith" predicate to filing a Chapter 11 petition. Earlier bankruptcy laws, for example, former Chapter X relating to corporate debtors specifically required that the court find that the petition "had been filed in good faith". However, the present Bankruptcy Code contains no such express requirement.

This Court, along with others, has opined that the concept of good faith is an elastic one which can be read into the statute on a limited ad hoc basis. However, this Court also cautioned that slavish adherence to a good faith concept may redound to the detriment of those non-debtor claimants who are or may putatively be beneficiaries of the reorganization process. [A] Chapter 11 filing creates a bankruptcy estate which exists for the benefit not simply of the debtor, but rather also for the benefit of all of the debtor's creditors and equity holders. The filing triggers the springing into existence of important constituencies which, along with the debtor, must be protected by a reorganization court. Accordingly, the intense focus on the debtor's motives in filing is misplaced.

Moreover, courts have generally held that the concept of good faith as of the filing date may only be applied where it is demonstrated that the jurisdiction of the bankruptcy court has been abused. One frequently cited decision declares that "[D]ismissal for lack of `good faith' . . . is merged into the power of the court to protect its jurisdictional integrity from schemes of improper petitioners seeking to circumvent jurisdictional restrictions and from petitioners with demonstrable frivolous purposes absent any economic reality." For example, this kind of abuse of jurisdiction is demonstrated where a reorganization debtor never operated legitimately or was formed for the sole purpose of filing.

In addition, where there has been a change in legal form prior to the filing from an ineligible entity to one able to file under this Chapter in order to avoid a foreclosure sale, a court should inquire into the debtor's good faith to ensure that the Code's purposes are not being abused and that the debtor is the kind of entity within the contemplation of the Code. However, whereas here a once viable business supporting employees and unsecured creditors has more recently been burdened with judgments that threaten to put it out of existence, unless and until rehabilitation has been shown to be unfeasible, the bankruptcy courts are a most appropriate harbor within which to weather the storm.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts are present in the Manville case. In Manville, it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization.

In short, there was justification for Manville to elect a course contemplating a viable court-supervised rehabilitation of the real debt owed by Manville to its real creditors. Manville's filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed a "once viable business supporting employees and unsecured creditors [which] has more recently been burdened with judgments [and suits] that threaten to put it out of existence." . . . Thus, its petition must be sustained.

[A] filing so as to substitute bankruptcy court procedures for estimation of these claims in and of itself does not constitute an abuse of the bankruptcy court's jurisdiction.

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville's filing does not abuse the jurisdictional integrity of this Court.

For the reasons set forth above, all four of the motions to dismiss the Manville petition are denied in their entirety.

3.17.2. IN RE SGL CARBON, 200 F.3d 154 (3d Cir. 1999)

SGL Carbon is a Delaware corporation. In 1997, the United States Department of Justice commenced an investigation of alleged price-fixing by manufacturers, including the SGL Carbon

Group. Soon thereafter, various steel producers filed class action antitrust lawsuits . . . against SGL Carbon.

On December 16, 1998, at the direction of [its parent], SGL Carbon filed a voluntary Chapter 11 bankruptcy petition. The bankruptcy filing contained a proposed reorganization plan under which only one type of creditor would be required to accept less than full cash payment for its account, namely the antitrust plaintiffs who obtained judgments against SGL Carbon. Under the plan, potential antitrust judgment creditors would receive credits against future purchases of SGL Carbon's product valid for 30 months following the plan's confirmation. The proposed plan also bars any claimant from bringing an action against SGL Carbon's affiliates, including its parent "based on" their claims against SGL Carbon.

The next day, on December 17, in a press release, SGL Carbon explained it had filed for bankruptcy "to protect itself against excessive demands made by plaintiffs in civil antitrust litigation and in order to achieve an expeditious resolution of the claims against it.

> SGL CARBON Corporation is financially healthy," said Wayne T. Burgess, SGL CARBON Corporation's president. "If we did not face [antitrust] claims for such excessive amounts, we would not have had to file for Chapter 11. We expect to continue our normal business operations. . . . However, because certain plaintiffs continue to make excessive and unreasonable demands, SGL CARBON Corporation believes the prospects of ever reaching a commercially practicable settlement with them are remote. After much consideration, SGL CARBON Corporation determined that the most appropriate course of action to address the situation without harming its business was to voluntarily file for chapter 11 protection."

Contemporaneous with the press release, SGL AG Chairman Robert Koehler conducted a telephone conference call with securities analysts, stating that SGL Carbon was "financially healthier" than before and denying the antitrust litigation was "starting to have a material impact on [SGL Carbon's] ongoing operations in the sense that ... [it was] starting to lose market share." He also stated that SGL Carbon's Chapter 11 petition was "fairly innovative [and] creative" because "usually Chapter 11 is used as protection against serious insolvency or credit problems, which is not the case [with SGL Carbon's petition]."

The District Court denied the motion to dismiss on April 23, 1999 assuming, without deciding, that 11 U.S.C. § 1112(b) imposes a duty of good faith upon bankruptcy petitioners. It further assumed this duty requires the proposed reorganization to further what it characterized as Chapter 11's purpose: "`to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and produce a return for its stockholders.'" The court made no findings that SGL Carbon filed for bankruptcy for reasons other than to improve its negotiating position with plaintiffs. But the court concluded the petition furthered the purpose of Chapter 11 because plaintiffs' litigation was imperiling SGL Carbon's operation by distracting its management, was potentially ruinous and could eventually force the company out of business. . .

The threshold issue is whether Chapter 11 petitions may be dismissed for "cause" under 11 U.S.C. § 1112(b) if not filed in good faith. . . . Chapter 11 bankruptcy petitions are subject to dismissal under 11 U.S.C. § 1112(b) unless filed in good faith.

Review and analysis of [the bankruptcy laws and relevant cases] disclose a common theme and objective [underlying the reorganization provisions]: avoidance of the consequences of economic dismemberment and liquidation, and the preservation of ongoing values in a manner which does equity and is fair to rights and interests of the parties affected. But the perimeters of this potential mark the borderline between fulfillment and perversion; between accomplishing the objectives of rehabilitation and reorganization, and the use of these statutory provisions to destroy and undermine the legitimate rights and interests of those intended to benefit by this statutory policy. That borderline is patrolled by courts of equity, armed with the doctrine of "good faith." A debtor who attempts to garner shelter under the Bankruptcy Code, therefore, must act in conformity with the Code's underlying principles.

Having determined that § 1112(b) imposes a good-faith requirement on Chapter 11 petitions, we consider whether SGL Carbon's Chapter 11 petition was filed in good faith.

Although there is some evidence that defending against the antitrust litigation occupied some officers' time, there is no evidence this "distraction" posed a "serious threat" to the company's operational well-being. . . . We also find clearly erroneous that SGL Carbon's Chapter 11 petition was filed at the appropriate time to avoid the possibility of a significant judgment that "could very well force [SGL Carbon] out of business." There is no evidence that the possible antitrust judgments might force SGL Carbon out of business. To the contrary, the record is replete with evidence of SGL Carbon's economic strength. At the time of filing, SGL Carbon's assets had a stipulated book value of $400 million, only $100,000 of which was encumbered. On the date of the petition, SGL Carbon had $276 million in fixed and non-disputed liabilities. Of those liabilities, only $26 million were held by outsiders as the remaining liabilities were either owed to or guaranteed by SGL AG. . . . In documents accompanying its petition, SGL Carbon estimated the liquidation value of the antitrust claims at $54 million. In contrast, no evidence was presented with respect to the amount sought by the antitrust plaintiffs beyond SGL Carbon's repeated characterization of their being "unreasonable."

Whether or not SGL Carbon faces a potentially crippling antitrust judgment, it is incorrect to conclude it had to file when it did. As noted, SGL Carbon faces no immediate financial difficulty. All the evidence shows that management repeatedly asserted the company was financially healthy at the time of the filing. Although the District Court believed the litigation might result in a judgment causing "financial and operational ruin" we believe that on the facts here, that assessment was premature. . . . The District Court was correct in noting that the Bankruptcy Code encourages early filing. It is well established that a debtor need not be insolvent before filing for bankruptcy protection. It also is clear that the drafters of the Bankruptcy Code understood the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation. Such encouragement, however, does not open the door to premature filing, nor does it allow for the filing of a bankruptcy petition that lacks a valid reorganizational purpose.

We do not hold that a company cannot file a valid Chapter 11 petition until after a massive judgment has been entered against it. Courts have allowed companies to seek the protections of

bankruptcy when faced with pending litigation that posed a serious threat to the companies' long term viability. In those cases, however, debtors experienced serious financial and/or managerial difficulties at the time of filing. In Johns-Manville, the debtor was facing significant financial difficulties. A growing wave of asbestos-related claims forced the debtor to either book a $1.9 billion reserve thereby triggering potential default on a $450 million debt which, in turn, could have forced partial liquidation, or file a Chapter 11 petition. Large judgments had already been entered against Johns-Manville and the prospect loomed of tens of thousands of asbestos health-related suits over the course of 20-30 years.

For these reasons, SGL Carbon's reliance on those cases is misplaced. The mere possibility of a future need to file, without more, does not establish that a petition was filed in "good faith. . . ." SGL Carbon, by its own account, and by all objective indicia, experienced no financial difficulty at the time of filing nor any significant managerial distraction. Although SGL Carbon may have to file for bankruptcy in the future, such an attenuated possibility standing alone is not sufficient to establish the good faith of its present petition.

Chapter 11 vests petitioners with considerable powers—the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, etc.—that can impose significant hardship on particular creditors. When financially troubled petitioners seek a chance to remain in business, the exercise of those powers is justified. But this is not so when a petitioner's aims lie outside those of the Bankruptcy Code. Courts, therefore, have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11. . . . Statements by SGL Carbon and its officials confirm the company did not need to reorganize under Chapter 11. . . . We are not convinced by SGL Carbon's claim that a Chapter 11 filing was necessary because we see no evidence the antitrust litigation was significantly harming its business relationships with the antitrust plaintiffs.

We also believe reliance on In re Johns-Manville is misplaced. As an initial matter, the Johns-Manville Court had a narrow view of what constitutes "good faith." After expressing doubt that § 1112(b) imposes a good-faith requirement in all Chapter 11 cases, the court suggested that a Chapter 11 petition lacks good faith only if filed by a creditor-less company formed as a sham solely for the purpose of filing a bankruptcy petition, by a company that never operated legitimately, or by a company wishing to forestall tax liability or deed of trust powers. [M]ost of the courts of appeals believe other facts and circumstances may evidence lack of good faith.

Johns-Manville is also factually distinguishable. In Johns-Manville, the bankruptcy court found the company had a "compelling" and "pressing" need to reorganize. As we have explained, SGL Carbon has no such need. . . .

[Petition Dismissed].

3.17.3. IN RE PADILLA, 222 F. 3d 1184 (9th Cir. 2000)

On April 19, 1996, Danny Padilla filed a voluntary petition for Chapter 7 liquidation. At the time, Padilla had a monthly take-home income of $1,950 and monthly expenses of $1,830. He had accrued almost $100,000 in credit card debt—a debt apparently related to gambling losses of $50,000 to $80,000 that Padilla had incurred during most of 1995. Padilla's assets consisted of his

house and personal property. His house, though mortgaged for $145,000, was valued at $115,000. His personal property, valued at $11,745, included cash, furnishings, a car, and other personal effects. Padilla claimed an exemption for all but $1,000 of his personal property.

On June 27, 1996, the Trustee moved to dismiss Padilla's petition for bad faith under 11 U.S.C. § 707(a) alleging that Padilla had engaged in credit card "bust-out." Credit card "bust-out" is a term used to describe a person's accumulation of a consumer debt in anticipation of filing for bankruptcy. The bankruptcy court granted the motion and dismissed Padilla's petition on September 10, 1996. On September 23, 1996, Padilla appealed to the BAP. The BAP held that, given the facts presented in the case, the bankruptcy court erred in concluding Padilla's filing constituted bad faith requiring dismissal under § 707(a). The BAP then reversed the bankruptcy court's order dismissing the petition and remanded the case for reinstatement. The BAP entered the judgment on October 24, 1997, and issued its mandate to the bankruptcy court on November 21, 1997. On December 22, 1997, the Trustee filed a notice of appeal to this court. The Trustee did not move to stay the BAP's judgment. In February 1998, the bankruptcy court, having reinstated Padilla's petition and proceeded with the bankruptcy, discharged Padilla's debts and closed the case. The Trustee did not object to the discharge.

The BAP held that the bankruptcy court erred in concluding Padilla's filing constituted bad faith requiring dismissal under § 707(a). This court reviews the BAP's decision de novo. See Preblich v. Battley, 181 F.3d 1048, 1051 (9th Cir. 1999) (stating that review of a district court's decision on appeal from a bankruptcy court is de novo); Arden v. Motel Partners (In re Arden), 176 F.3d 1226, 1227 (9th Cir.1999) (reviewing the BAP's decision de novo). In essence, we review *de novo* whether the bankruptcy court erred in concluding that bad faith is a ground for dismissal under § 707(a). We affirm the BAP's conclusion that § 707(a) does not apply here.

Under § 707(a), a court may dismiss a bankruptcy liquidation petition filed under Chapter 7 of the Bankruptcy Code only after notice and a hearing and only for cause, including—

(1) unreasonable delay by the debtor that is prejudicial to creditors;

(2) nonpayment of any fees or charges required under chapter 123 of title 28; and

(3) failure of the debtor in a voluntary case to file, within fifteen days ..., the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

11 U.S.C.A. § 707(a) (West 1993) (italics added). The grounds that § 707(a) lists as providing "cause" for dismissal are illustrative and not exhaustive.

Whether bad faith can provide "cause" for dismissing a Chapter 7 bankruptcy petition pursuant to § 707(a) is a matter of first impression for this court. The Sixth Circuit and a host of bankruptcy courts that have considered the issue have found bad faith to be a ground for dismissal under § 707(a). As is discussed below, we agree with the Eighth Circuit that bad faith as a general proposition does not provide "cause" to dismiss a Chapter 7 petition under § 707(a).

Balanced against the relief that the Bankruptcy Code makes available to debtors are the protections the Code affords creditors and, through the United States trustee or the court itself, the public. In the Chapter 7 context, four provisions allow creditors and trustees to object to the discharge of debt: (1) [exceptions to discharge under Section 523, (2) denial of discharge under under Section 727(a)(2), (c)(1)], (3) the court on its own or on a motion by the United States trustee may dismiss a Chapter 7 petition if the debts are primarily consumer debts and if granting relief

would be a **substantial abuse** of the provisions of Chapter 7 [Section] 707(b); and (4) court may dismiss "for cause" and sets forth three particular grounds that, including unspecified others, provide "cause" for dismissal. see 11 U.S.C. § 707(a)(1)-(3). Section 707(a) is the only ground raised by the Trustee.

The three explicit grounds contained in § 707(a) have been described as being "technical and procedural" violations of the Bankruptcy Code.

Statutory construction canons require that "[w]here both a specific and a general statute address the same subject matter, the specific one takes precedence regardless of the sequence of the enactment, and must be applied first."

Of the four Code provisions that protect the public and creditors from Chapter 7 debtors, three are specific in nature in that they can be used only in particular circumstances. See 11 U.S.C. § 523(a)(2)(A), (c)(1) (indebtedness obtained by fraud); 11 U.S.C. § 727(a)(2), (c)(1) (transfer of assets with intent to defraud a creditor); 11 U.S.C. § 707(b) (discharge of consumer debts would be substantial abuse of Chapter 7). Therefore, debtor misconduct falling within the particular circumstances addressed by one of the three provisions must be analyzed under that provision.

The fourth provision, 11 U.S.C. § 707(a), in reciting three technical and procedural grounds that provide "cause" for dismissal, functions as a "specific" Code provision. Yet, some courts have focused on the word "including," in § 707(a) and used it as a "general" Code provision that allows dismissal for bad faith. No provision that protects Chapter 7 creditors and the public explicitly uses the words "good faith" or "bad faith." Therefore, the question of whether a Chapter 7 debtor's bad faith can provide "cause" for dismissal or grounds for preventing discharge under §§ 523(a)(2)(A), 727(a)(2), 707(b) or 707(a) necessarily depends on the nature of the debtor's actions or inactions that have given rise to the "bad faith" label and whether they are within the contemplation of specific Code provisions. We agree with the Eighth Circuit which stated that

> some conduct constituting cause to dismiss a Chapter 7 petition may readily be characterized as bad faith. But framing the issue in terms of bad faith may tend to misdirect the inquiry away from the fundamental principles and purposes of Chapter 7. Thus, we think the § 707(a) analysis is better conducted under the statutory standard, "for cause."

Huckfeldt, 39 F.3d at 832.

We note that Chapters 11 and 13 of the Bankruptcy Code each contain a "dismissal for cause" provision that is structured like § 707(a) and includes the same or similar examples of "cause" as § 707(a). However, under the Chapter 11 and Chapter 13 provisions we have held that bad faith does provide "cause" to dismiss Chapter 11 and Chapter 13 bankruptcy petitions. What distinguishes Chapters 11 and 13 from Chapter 7 is the language of the Bankruptcy Code itself and the post-filing relationship between the debtor and his creditors. The Bankruptcy Code specifically mentions good faith in Chapters 11 and 13 when it permits a court to confirm a payment plan only if it is proposed in good faith. No mention of good faith or bad faith is made in Chapter 7. Also, the post-filing debtor-creditor relationship is markedly different in liquidation and reorganization bankruptcies. Chapters 11 and 13, both reorganization chapters, permit the debtor to "retain its assets and reorder its contractual obligations to its creditors. In return for these benefits, . . . the debtor [must] approach its new relationship with the creditors in good faith ..."

Chapter 7, a liquidation chapter, "requires no ongoing relationship between the debtor and its creditors" and should be available to any debtor willing to surrender all of its nonexempt assets, "regardless of whether the debtor's motive in seeking such a remedy was grounded in good faith." The Bankruptcy Code's language and the protracted relationship between reorganization debtors and their creditors lead us to conclude that bad faith per se can properly constitute "cause" for dismissal of a Chapter 11 or Chapter 13 petition but not of a Chapter 7 petition under § 707(a).[6]

Having discarded the "bad faith" label in favor of simply examining the actions of the debtor that are complained of, and assuming arguendo that Padilla's prefiling activities constitute credit card bust-out, the remaining issue is whether Padilla's credit card bust-out provides "cause" for dismissal under § 707(a). **We begin by observing that there is no evidence that Padilla violated any technical or procedural requirements of Chapter 7**. The record reveals no failure to pay filing fees or to file necessary information. Padilla did not falsify bankruptcy forms or cause delays during the administration of bankruptcy proceeding. Thus, Padilla's bankruptcy petition can only be dismissed under § 707(a) if credit card bust-out is not a type of misconduct or cause contemplated by any specific Code provision applicable to Chapter 7 petitions.

Padilla's debts—consisting of credit card debt and a mortgage—are solely consumer debts. Section 707(b) concerns consumer debt and provides in relevant part that

> [a]fter notice and a hearing, the court, on its own motion or on a motion by the United States trustee, but not at the 1194*1194 request or suggestion of any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor.

The history of § 707(b) demonstrates that this subsection, rather than § 707(a), was intended as the mechanism by which the court or the United States trustee could address general concerns regarding discharge of consumer debt. In 1978, when Congress enacted the Bankruptcy Code, § 707 comprised only part of what is now § 707(a). There was no § 707(b).

> Within several years the consumer credit industry mobilized in an attempt to curtail the access of debtors to Chapter 7 relief .... This move was brought about by the increasingly popular perception that people were using the bankruptcy system, not to extricate themselves from an unfortunate situation, but rather as a method of avoiding debts even though they were not suffering economic hardship and possessed future income sufficient to meet their obligations.... According to the consumer credit industry, this "needless discharge" of debt led to the shifting of the repayment burden for literally billions of dollars of debt to the public at large, and principally to those who utilized consumer credit at increasingly higher interest rates.

Robert M. Thompson, Comment, Consumer Bankruptcy: Substantial Abuse and Section 707 of the Bankruptcy Code, 55 Mo. L.Rev. 247, 249 (1990). Finally, "[i]n response to persistent

pressure from creditors, who felt that debtors were avoiding bothersome unsecured debts which they could easily repay, Congress enacted section 707(b) in the Bankruptcy Amendments and Federal Judgeship Act of 1984, ... to address some of the perceived abuses of chapter 7." Had "cause" in § 707(a) been broadly construed, § 707(b) would have been unnecessary. Therefore, Padilla's credit card bust-out, a consumer debt, is a type of misconduct contemplated by § 707(b).

We hold that Padilla's alleged credit card "bust out" did not constitute cause under § 707(a) and thus the bankruptcy court's dismissal of Padilla's petition pursuant to § 707(a) was improper.

3.18. Voluntary and Involuntary Conversion and Dismissal

Each chapter of the Bankruptcy Code contains rules for converting and dismissing a bankruptcy case. The general rule is that voluntary conversion (at the debtor's request) from any chapter to Chapter 13 is freely available to the debtor, while involuntary conversion to Chapter 13 is never available: Chapter 13 is always voluntary. *See* 11 U.S.C. §§ 706(a) (debtor's right to convert to Chapter 11 or 13); 1307(a) (debtor's right to convert to Chapter 7), 1112(4)(d) (debtor's right to convert to Chapter 13).

Similarly, debtors have an absolute right to dismiss their Chapter 13 cases at any time. 11 U.S.C. § 1307(b). However, a few courts have ignored the clear mandate of the voluntary conversion statute in cases where the debtor was attempting to escape from the trustee's scrutiny of fraudulent conduct. *See In re Parker*, 351 B.R. 790 (Bankr. N.D. Ga. 2006); *In re Fileccia*, No. 06-0541, 2007 Bankr. LEXIS 1924, *11 (Bankr. M.D. Tenn. June 6, 2007). A case that was voluntarily converted from Chapter 7 to Chapter 13 can be reconverted back to Chapter 7 over the debtor's objection. *See* 11 U.S.C. § 1307(b).

Cases may be involuntarily converted from Chapter 7 to 11, Chapter 11 to 7, or dismissed from any chapter, after notice and a hearing upon a showing of "cause" for conversion or dismissal. 11 U.S.C. §§ 706(b); 1112(b)(1); 1307(c). Most of the cases involving involuntary conversion arise under Chapter 11, where a creditor seeks liquidation rather than further plan negotiations and delay. The Bankruptcy Code contains a long list of conduct constituting "cause" for converting from Chapter 11 to Chapter 7, with the focus being on the debtor's post-petition Bankruptcy Code violations, or an inability to effectuate a plan after a reasonable time. *See* 11 U.S.C. § 1112(b)(4).

Prepetition bad faith is not a factor listed as an example of "cause" in the Chapter 11 dismissal rules. Yet, the Courts have generally found prepetition bad faith to constitute grounds for dismissal. *See In re Little Creek Dev. Co.*, 779 F.2d 1068, 1071 (5th Cir. 1986) ("Every bankruptcy statute since 1898 has incorporated literally, or by judicial interpretation, a standard of good faith for the commencement, prosecution, and confirmation of bankruptcy proceedings."); 7-1112 Collier on Bankruptcy P 1112.07[5] (noting overlap between bad faith and "cause" for dismissal).

Some courts have added an objective futility requirement to bad faith dismissals of chapter proceedings, refusing to dismiss cases subjectively filed in bath faith if the case has a proper reorganization purpose and likelihood. *In re Harmony Holdings, LLC*, 393 B.R. 409, 418 (Bankr. D.S.C. 2008); *Carolin Corp. v. Miller*, 886 F.2d 693, 701 (4th Cir. N.C. 1989). In any case, the courts have continued to recognize bad faith dismissals in Chapter 11 cases, even after the 2005

BAPCPA amendments defined pre-petition bad faith as an element of "abuse" by consumer debtors under Section 707(b), rather than as an element of "cause" for dismissal generally under Section 707(a).

3.19. Fees, Surcharges and Sanctions

3.19.1. UNITED STATES v. KRAS, 409 U.S. 434 (1973)

The Bankruptcy Act and one of this Court's complementary Orders in Bankruptcy impose fees and make the payment of those fees a condition to a discharge in voluntary bankruptcy.

Appellee Kras, an indigent petitioner in bankruptcy, challenged the fees on Fifth Amendment grounds. The District Court held the fee provisions to be unconstitutional as applied to Kras.

Section 14 (b) (2) of the Bankruptcy Act provides that, upon the expiration of the time fixed by the court for filing of objections, "the court shall discharge the bankrupt if no objection has been filed and if the filing fees required to be paid by this title have been paid in full." Section 14 (c) similarly provides that the court "shall grant the discharge unless satisfied that the bankrupt. . . (8) has failed to pay the filing fees required to be paid by this title in full." Section 59 (g), 11 U. S. C. § 95 (g), relates to the dismissal of a petition in bankruptcy and states that "in the case of a dismissal for failure to pay the costs," notice to creditors shall not be required. Three separate sections of the thus contemplate the imposition of fees and condition a discharge upon payment of those fees.

[The Court noted that Kras's filing fees totaled $50, and could be paid in installments. He submitted an affidavit establishing that he, his wife, and two children were living on an income of $300 per month, and $366 of public assistance, and that he had no non-exempt assets].

Because of his poverty, Kras is wholly unable to pay or promise to pay the bankruptcy fees, even in small installments. He has been unable to borrow money. The New York City Department of Social Services refuses to allot money for payment of the fees. He has no prospect of immediate employment.

Kras seeks a discharge in bankruptcy of $6,428.69 in total indebtedness in order to relieve himself and his family of the distress of financial insolvency and creditor harassment and in order to make a new start in life. It is especially important that he obtain a discharge of his debt to Metropolitan soon "because until that is cleared up Metropolitan will continue to falsely charge me with fraud and give me bad references which prevent my getting employment."

The District Court's opinion contains an order granting Kras' motion for leave to file his petition in bankruptcy without prepayment of fees. He was adjudged a bankrupt. Later, the referee, upon consent of the parties, entered an order allowing Kras to conduct all necessary proceedings in bankruptcy up to but not including discharge. The referee stayed the discharge pending disposition of this appeal.

[The Court held that there were no provisions in the bankruptcy statute at the time that would allow a debtor to file bankruptcy and obtain a discharge without paying filing fees.] Neither

do we perceive any common-law right to proceed without payment of fees. Congress, of course, sometime might conclude that [a fee waiver provision] should be made applicable to bankruptcy and legislate accordingly.

The District Court went on to hold, however, that the prescribed fees, payment of which was required as a condition precedent to discharge, served to deny Kras "his Fifth Amendment right of due process, including equal protection." It held that a discharge in bankruptcy was a "fundamental interest" that could be denied only when a "compelling government interest" was demonstrated. It noted that provision should be made by the referee for the survival, beyond bankruptcy, of the bankrupt's obligation to pay the fees. The court rested its decision primarily upon *Boddie v. Connecticut*, 401 U. S. 371 (1971). A number of other district courts and bankruptcy referees have reached the same result.

Kras contends that his case falls squarely within *Boddie*. The Government, on the other hand, stresses the differences between divorce (with which *Boddie* was concerned) and bankruptcy, and claims that *Boddie* is not controlling and that the fee requirements constitute a reasonable exercise of Congress' plenary power over bankruptcy.

Boddie was a challenge by welfare recipients to certain Connecticut procedures, including the payment of court fees and costs, that allegedly restricted their access to the courts for divorce. The plaintiffs, simply by reason of their indigency, were unable to bring their actions. The Court reversed a district court judgment that a State could limit access to its courts by fees "which effectively bar persons on relief from commencing actions therein." Mr. Justice Harlan, writing for the Court, stressed state monopolization of the means for legally dissolving marriage and identified the would-be indigent divorce plaintiff with any other action's impoverished defendant forced into court by the institution of a lawsuit against him. He declared that "a meaningful opportunity to be heard" was firmly imbedded in our due process jurisprudence, and that this was to be protected against denial by laws that operate to jeopardize it for particular individuals. The Court then concluded that Connecticut's refusal to admit these good-faith divorce plaintiffs to its courts equated with the denial of an opportunity to be heard and, in the absence of a sufficient countervailing justification for the State's action, a denial of due process.

But the Court emphasized that "we go no further than necessary to dispose of the case before us."

"We do not decide that access for all individuals to the courts is a right that is, in all circumstances, guaranteed by the Due Process Clause of the Fourteenth Amendment so that its exercise may not be placed beyond the reach of any individual, for, as we have already noted, in the case before us this right is the exclusive precondition to the adjustment of a fundamental human relationship. The requirement that these appellants resort to the judicial process is entirely a state-created matter. Thus we hold only that a State may not, consistent with the obligations imposed on it by the Due Process Clause of the Fourteenth Amendment, pre-empt the right to dissolve this legal relationship without affording all citizens access to the means it has prescribed for doing so."

We agree with the Government that our decision in *Boddie* does not control the disposition of this case and that the District Court's reliance upon *Boddie* is misplaced.

Boddie was based on the notion that a State cannot deny access, simply because of one's poverty, to a "judicial proceeding [that is] the only effective means of resolving the dispute at hand." Throughout the opinion there is constant and recurring reference to Connecticut's exclusive

control over the establishment, enforcement, and dissolution of the marital relationship. The Court emphasized that "marriage involves interests of basic importance in our society," and spoke of "state monopolization of the means for legally dissolving this relationship," "[R]esort to the state courts [was] the only avenue to dissolution of . . . marriages," which was "not only the paramount dispute-settlement technique, but, in fact, the only available one." The Court acknowledged that it knew "of no instance where two consenting adults may divorce and mutually liberate themselves from the constraints of legal obligations that go with marriage, and more fundamentally the prohibition against remarriage, without invoking the State's judicial machinery." In the light of all this, we concluded that resort to the judicial process was "no more voluntary in a realistic sense than that of the defendant called upon to defend his interests in court" and we resolved the case "in light of the principles enunciated in our due process decisions that delimit rights of defendants compelled to litigate their differences in the judicial forum."

The appellants in *Boddie*, on the one hand, and Robert Kras, on the other, stand in materially different postures. The denial of access to the judicial forum in *Boddie* touched directly, as has been noted, on the marital relationship and on the associational interests that surround the establishment and dissolution of that relationship. On many occasions we have recognized the fundamental importance of these interests under our Constitution. The *Boddie* appellants' inability to dissolve their marriages seriously impaired their freedom to pursue other protected associational activities. Kras' alleged interest in the elimination of his debt burden, and in obtaining his desired new start in life, although important and so recognized by the enactment of the Bankruptcy Act, does not rise to the same constitutional level. If Kras is not discharged in bankruptcy, his position will not be materially altered in any constitutional sense. Gaining or not gaining a discharge will effect no change with respect to basic necessities. We see no fundamental interest that is gained or lost depending on the availability of a discharge in bankruptcy.

Nor is the Government's control over the establishment, enforcement, or dissolution of debts nearly so exclusive as Connecticut's control over the marriage relationship in *Boddie*. In contrast with divorce, bankruptcy is not the only method available to a debtor for the adjustment of his legal relationship with his creditors. The utter exclusiveness of court access and court remedy, as has been noted, was a potent factor in *Boddie*. But "[w]ithout a prior judicial imprimatur, individuals may freely enter into and rescind commercial contracts. . . .".

However unrealistic the remedy may be in a particular situation, a debtor, in theory, and often in actuality, may adjust his debts by negotiated agreement with his creditors. At times the happy passage of the applicable limitation period, or other acceptable creditor arrangement, will provide the answer. Government's role with respect to the private commercial relationship is qualitatively and quantitatively different from its role in the establishment, enforcement, and dissolution of marriage.

Resort to the court, therefore, is not Kras' sole path to relief. *Boddie's* emphasis on exclusivity finds no counterpart in the bankrupt's situation.

We are also of the opinion that the filing fee requirement does not deny Kras the equal protection of the laws. Bankruptcy is hardly akin to free speech or marriage or to those other rights, so many of which are imbedded in the First Amendment, that the Court has come to regard as fundamental and that demand the lofty requirement of a compelling governmental interest before they may be significantly regulated. Neither does it touch upon what have been said to be the

suspect criteria of race, nationality, or alienage. Instead, bankruptcy legislation is in the area of economics and social welfare. This being so, the applicable standard, in measuring the propriety of Congress' classification, is that of rational justification.

There is no constitutional right to obtain a discharge of one's debts in bankruptcy. The Constitution, Art. I, § 8, cl. 4, merely authorizes the Congress to "establish. . . uniform Laws on the subject of Bankruptcies throughout the United States." Although the first bankruptcy law in England was enacted in 1542, and a discharge provision first appeared in 1705, primarily as a reward for cooperating debtors, voluntary bankruptcy was not known in this country at the adoption of the Constitution. Indeed, for the entire period prior to the present Act of 1898, the Nation was without a federal bankruptcy law except for three short periods aggregating about 15 1/2 years. Professor MacLachlan has said that the development of the discharge "represents an independent. . . public policy in favor of extricating an insolvent debtor from what would otherwise be a financial impasse." But this obviously is a legislatively created benefit, not a constitutional one, and, as noted, it was a benefit withheld, save for three short periods, during the first 110 years of the Nation's life. The mere fact that Congress has delegated to the District Court supervision over the proceedings by which a petition for discharge is processed does not convert a statutory benefit into a constitutional right of access to a court. Then, too, Congress might have delegated the responsibility to an administrative agency.

The rational basis for the fee requirement is readily apparent. Congressional power over bankruptcy, of course, is plenary and exclusive. By the 1946 Amendment, as has been noted, abolished the theretofore existing practices of the pauper petition and of compensating the referee from the fees he collected. It replaced that system with one for salaried referees and for fixed fees for every petition filed and a specified percentage of distributable assets. It sought to make the system self-sustaining and paid for by those who use it rather than by tax revenues drawn from the public at large. The propriety of the requirement that the fees be paid ultimately has been recognized even by those district courts that have held the payment of the fee as a precondition to a discharge to be unconstitutional, for those courts would make the payments survive the bankruptcy as a continuing obligation of the bankrupt.

Further, the reasonableness of the structure Congress produced, and congressional concern for the debtor, are apparent from the provisions permitting the debtor to file his petition without payment of any fee, with consequent freedom of subsequent earnings and of after-acquired assets from the claims of then-existing obligations. These provisions, coupled with the bankrupt's ability to obtain a stay of all debt enforcement actions pending at the filing of the petition or thereafter commenced, enable a bankrupt to terminate his harassment by creditors, to protect his future earnings and property, and to have his new start with a minimum of effort and financial obligation. They serve also, as an incidental effect, to promote and not to defeat the purpose of making the bankruptcy system financially self-sufficient.

If the $50 filing fees are paid in installments over six months as General Order No. 35 (4) permits on a proper showing, the required average weekly payment is $1.92. If the payment period is extended for the additional three months as the Order permits, the average weekly payment is lowered to $1.28.[8] This is a sum less than the payments Kras makes on his couch of negligible value in storage, and less than the price of a movie and little more than the cost of a pack or two of cigarettes. If, as Kras alleges in his affidavit, a discharge in bankruptcy will afford him that new start he so desires, and the Metropolitan then no longer will charge him with fraud and give him

bad references, and if he really needs and desires that discharge, this much available revenue should be within his able-bodied reach when the adjudication in bankruptcy has stayed collection and has brought to a halt whatever harassment, if any, he may have sustained from creditors.

Mr. Justice Harlan, in his opinion for the Court in *Boddie*, meticulously pointed out, as we have noted above, that the Court went "no further than necessary to dispose of the case before us" and did "not decide that access for all individuals to the courts is a right that is, in all circumstances, guaranteed by the Due Process Clause of the Fourteenth Amendment so that its exercise may not be placed beyond the reach of any individual." The Court obviously stopped short of an unlimited rule that an indigent at all times and in all cases has the right to relief without the payment of fees.

We decline to extend the principle of *Boddie* to the no-asset bankruptcy proceeding. That relief, if it is to be forthcoming, should originate with Congress.

3.19.2. LAW v. SIEGEL, 134 S.Ct. 1188 (2014)

The Bankruptcy Code provides that a debtor may exempt certain assets from the bankruptcy estate. It further provides that exempt assets generally are not liable for any expenses associated with administering the estate. In this case, we consider whether a bankruptcy court nonetheless may order that a debtor's exempt assets be used to pay administrative expenses incurred as a result of the debtor's misconduct.

The filing of a bankruptcy petition under Chapter 7 creates a bankruptcy "estate" generally comprising all of the debtor's property. § 541(a)(1). The estate is placed under the control of a trustee, who is responsible for managing liquidation of the estate's assets and distribution of the proceeds. § 704(a)(1). The Code authorizes the debtor to "exempt," however, certain kinds of property from the estate, enabling him to retain those assets post-bankruptcy. § 522(b)(1). Except in particular situations specified in the Code, exempt property "is not liable" for the payment of "any [prepetition] debt" or "any administrative expense." § 522(c), (k).

The "homestead exemption," protects up to $22,975 in equity in the debtor's residence. The debtor may elect, however, to forgo the § 522(d) exemptions and instead claim whatever exemptions are available under applicable state or local law. § 522(b)(3)(A). Some States provide homestead exemptions that are more generous than the federal exemption; some provide less generous versions; but nearly every State provides some type of homestead exemption.

Petitioner, Stephen Law, filed for Chapter 7 bankruptcy in 2004, and respondent, Alfred H. Siegel, was appointed to serve as trustee. The estate's only significant asset was Law's house in Hacienda Heights, California. On a schedule filed with the Bankruptcy Court, Law valued the house at $363,348 and claimed that $75,000 of its value was covered by California's homestead exemption. He also reported that the house was subject to two voluntary liens: a note and deed of trust for $147,156.52 in favor of Washington Mutual Bank, and a second note and deed of trust for $156,929.04 in favor of "Lin's Mortgage & Associates." Law thus represented that there was no equity in the house that could be recovered for his other creditors, because the sum of the two liens exceeded the house's nonexempt value.

If Law's representations had been accurate, he presumably would have been able to retain the house, since Siegel would have had no reason to pursue its sale. Instead, a few months after

Law's petition was filed, Siegel initiated an adversary proceeding alleging that the lien in favor of "Lin's Mortgage & Associates" was fraudulent. The deed of trust supporting that lien had been recorded by Law in 1999 and reflected a debt to someone named "Lili Lin." Not one but two individuals claiming to be Lili Lin ultimately responded to Siegel's complaint. One, Lili Lin of Artesia, California, was a former acquaintance of Law's who denied ever having loaned him money and described his repeated efforts to involve her in various sham transactions relating to the disputed deed of trust. That Lili Lin promptly entered into a stipulated judgment disclaiming any interest in the house. But that was not the end of the matter, because the second "Lili Lin" claimed to be the true beneficiary of the disputed deed of trust. Over the next five years, this "Lili Lin" managed — despite supposedly living in China and speaking no English — to engage in extensive and costly litigation, including several appeals, contesting the avoidance of the deed of trust and Siegel's subsequent sale of the house.

Finally, in 2009, the Bankruptcy Court entered an order concluding that "no person named Lili Lin ever made a loan to [Law] in exchange for the disputed deed of trust." The court found that "the loan was a fiction, meant to preserve [Law's] equity in his residence beyond what he was entitled to exempt" by perpetrating "a fraud on his creditors and the court." With regard to the second "Lili Lin," the court declared itself "unpersuaded that Lili Lin of China signed or approved any declaration or pleading purporting to come from her." Rather, it said, the "most plausible conclusion" was that Law himself had "authored, signed, and filed some or all of these papers." It also found that Law had submitted false evidence "in an effort to persuade the court that Lili Lin of China — rather than Lili Lin of Artesia — was the true holder of the lien on his residence." The court determined that Siegel had incurred more than $500,000 in attorney's fees overcoming Law's fraudulent misrepresentations. It therefore granted Siegel's motion to "surcharge" the entirety of Law's $75,000 homestead exemption, making those funds available to defray Siegel's attorney's fees.

A bankruptcy court has statutory authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Bankruptcy Code. 11 U.S.C. § 105(a). And it may also possess "inherent power ... to sanction `abusive litigation practices.'" But in exercising those statutory and inherent powers, a bankruptcy court may not contravene specific statutory provisions.

It is hornbook law that § 105(a) "does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code." Section 105(a) confers authority to "carry out" the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits. That is simply an application of the axiom that a statute's general permission to take actions of a certain type must yield to a specific prohibition found elsewhere. We have long held that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of" the Bankruptcy Code.

Thus, the Bankruptcy Court's "surcharge" was unauthorized if it contravened a specific provision of the Code. We conclude that it did. Section 522 (by reference to California law) entitled Law to exempt $75,000 of equity in his home from the bankruptcy estate. And it made that $75,000 "not liable for payment of any administrative expense." The reasonable attorney's fees Siegel incurred defeating the "Lili Lin" lien were indubitably an administrative expense.

The Bankruptcy Court thus violated § 522's express terms when it ordered that the $75,000 protected by Law's homestead exemption be made available to pay Siegel's attorney's fees, an administrative expense. In doing so, the court exceeded the limits of its authority under § 105(a) and its inherent powers.

Insofar as Siegel and the United States equate the Bankruptcy Court's surcharge with an outright denial of Law's homestead exemption, their arguments founder upon this case's procedural history. The Bankruptcy Appellate Panel stated that because no one "timely oppose[d] [Law]'s homestead exemption claim," the exemption "became final" before the Bankruptcy Court imposed the surcharge. We have held that a trustee's failure to make a timely objection prevents him from challenging an exemption. *Taylor v. Freeland & Kronz*, 503 U.S. 638, 643-644, 112 S.Ct. 1644, 118 L.Ed.2d 280 (1992).

But even assuming the Bankruptcy Court could have revisited Law's entitlement to the exemption, § 522 does not give courts discretion to grant or withhold exemptions based on whatever considerations they deem appropriate. Rather, the statute exhaustively specifies the criteria that will render property exempt. Siegel insists that because § 522(b) says that the debtor "may exempt" certain property, rather than that he "shall be entitled" to do so, the court retains discretion to grant or deny exemptions even when the statutory criteria are met. But the subject of "may exempt" in § 522(b) is the debtor, not the court, so it is the debtor in whom the statute vests discretion. A debtor need not invoke an exemption to which the statute entitles him; but if he does, the court may not refuse to honor the exemption absent a valid statutory basis for doing so.

Moreover, § 522 sets forth a number of carefully calibrated exceptions and limitations, some of which relate to the debtor's misconduct. For example, § 522(c) makes exempt property liable for certain kinds of prepetition debts, including debts arising from tax fraud, fraud in connection with student loans, and other specified types of wrongdoing. Section 522(o) prevents a debtor from claiming a homestead exemption to the extent he acquired the homestead with nonexempt property in the previous 10 years "with the intent to hinder, delay, or defraud a creditor." And § 522(q) caps a debtor's homestead exemption at approximately $150,000 (but does not eliminate it entirely) where the debtor has been convicted of a felony that shows "that the filing of the case was an abuse of the provisions of" the Code, or where the debtor owes a debt arising from specified wrongful acts — such as securities fraud, civil violations of the Racketeer Influenced and Corrupt Organizations Act, or "any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years." § 522(q) and note following § 522. The Code's meticulous — not to say mind-numbingly detailed — enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exceptions.

Siegel points out that a handful of courts have claimed authority to disallow an exemption (or to bar a debtor from amending his schedules to claim an exemption, which is much the same thing) based on the debtor's fraudulent concealment of the asset alleged to be exempt. He suggests that those decisions reflect a general, equitable power in bankruptcy courts to deny exemptions based on a debtor's bad-faith conduct. For the reasons we have given, the Bankruptcy Code admits no such power. It is of course true that when a debtor claims a state-created exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption. But federal law provides no authority for bankruptcy courts to deny an exemption on a ground not specified in the Code.

We acknowledge that our ruling forces Siegel to shoulder a heavy financial burden resulting from Law's egregious misconduct, and that it may produce inequitable results for trustees and creditors in other cases. We have recognized, however, that in crafting the provisions of § 522, "Congress balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions 1198*1198 visit on creditors." The same can be said of the limits imposed on recovery of administrative expenses by trustees. For the reasons we have explained, it is not for courts to alter the balance struck by the statute.

Our decision today does not denude bankruptcy courts of the essential "authority to respond to debtor misconduct with meaningful sanctions." There is ample authority to deny the dishonest debtor a discharge. See § 727(a)(2)-(6). (That sanction lacks bite here, since by reason of a postpetition settlement between Siegel and Law's major creditor, Law has no debts left to discharge; but that will not often be the case.) In addition, Federal Rule of Bankruptcy Procedure 9011 — bankruptcy's analogue to Civil Rule 11 — authorizes the court to impose sanctions for bad-faith litigation conduct, which may include "an order directing payment ... of some or all of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation." The court may also possess further sanctioning authority under either § 105(a) or its inherent powers. And because it arises postpetition, a bankruptcy court's monetary sanction survives the bankruptcy case and is thereafter enforceable through the normal procedures for collecting money judgments. Fraudulent conduct in a bankruptcy case may also subject a debtor to criminal prosecution under 18 U.S.C. § 152, which carries a maximum penalty of five years' imprisonment.

But whatever other sanctions a bankruptcy court may impose on a dishonest debtor, it may not contravene express provisions of the Bankruptcy Code by ordering that the debtor's exempt property be used to pay debts and expenses for which that property is not liable under the Code.

3.20. Dismissal of Consumer Chapter 7 Cases for "Abuse" – The Means Test

Section 707(b) of the Bankruptcy Code provides for dismissal in consumer bankruptcy cases if the granting of relief would be an "abuse" of Chapter 7. Prior to 2005, the standard was "substantial abuse." Courts engaged in a case-by-case analysis to determine whether the filing was abusive. Specifically, Bankruptcy Courts could dismiss cases if debtors could afford to pay creditors, using a forward looking approach based on the debtor's expected income and reasonable living expenses.

In performing the case by case analysis under Section 707(b), bankruptcy judges developed reputations in the local community for leniency or strictness. Debtors who leased or financed fancy homes or cars ran the risk of having their expenses disallowed in the calculation of reasonable living expenses. This practice led to the axiom that it was dangerous for a debtor filing bankruptcy to drive a better car than the bankruptcy judge.

In the 2005 BAPCPA amendments, Congress lowered the standard from "substantial abuse" to "abuse" (not a very important change since both standards would ultimately be decided on the basis of the Bankruptcy Judge's personal views), and created a presumption of abuse for consumer debtors who failed to satisfy a complex and rigid mathematical "means" test. The stated

goal of the means test was to force debtors who could afford to pay some portion of their debts into Chapter 13. Unfortunately, the rigid means test is subject to manipulation, is overbroad, and is poorly tailored to its objective.

It is important to first note that the entirety of Section 707(b) (dismissal for abuse and presumption of abuse under the "means test") applies only to individual **consumer** debtors – legal entities like corporations and partnerships, and individual debtors with primarily **business** debts, are not subject to the "abuse" standard at all.

Second, many debtors easily satisfy the "means test" without performing all of the complex mathematics. The place to begin reading the means test statute is in the middle - Sections 707(b)(6) and (b)(7). Actually, the place to begin reading is Section 101(10A) – the definition of "current monthly income" – which is the cornerstone of the test. Read these three provisions, Section 101(10)(A), Sections 707(b)(6) and (b)(7), carefully and answer the following questions.

3.21. Practice Problems: Dismissal for Abuse – The Means Test, Part One

Problem 1. Individual debtor filed her bankruptcy petition on **October 17** of the current year. The following schedule shows the debtor's income and expenses for the current year. Calculate the Debtor's "current monthly income." *See* 11 U.S.C. § 101(10A).

INCOME	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct 1-17	TOTAL
Wages	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200				$ 1,200	$ 800	$ 8,000
Tips	$ 245	$ 290	$ 265	$ 225	$ 200				$ 250	$ 125	$ 1,600
Social Sec Disability						$ 350	$ 350	$ 350			$ 1,050
Unemployment						$ 150	$ 150	$ 150			$ 450
Family Gifts (tax free)						$ 200	$ 200	$ 200			$ 600
Total Income	***$ 1,445***	***$ 1,490***	***$ 1,465***	***$ 1,425***	***$ 1,400***	***$ 700***	***$ 700***	***$ 700***	***$ 1,450***	***$ 925***	***$ 11,700***
EXPENSES											
Rent	$ 375	$ 375	$ 375	$ 375	$ 375	$ 375	$ 375	$ 375	$ 375	$ 375	$ 3,750
Food	$ 150	$ 160	$ 145	$ 125	$ 160	$ 120	$ 110	$ 98	$ 120	$ 62	$ 1,250
Utilities	$ 60	$ 55	$ 50	$ 40	$ 35	$ 35	$ 35	$ 35	$ 35	$ 15	$ 395
Cell Phone	$ 90	$ 90	$ 90	$ 90	$ 90	$ 90	$ 90	$ 90	$ 90	$ 90	$ 900
Cable TV and Internet	$ 120	$ 120	$ 120	$ 120	$ 120	$ 120	$ 120	$ 120	$ 120	$ 120	$ 1,200
Car Payment	$ 145	$ 145	$ 145	$ 145	$ 145	$ 145	$ 145	$ 145	$ 145	$ 145	$ 1,450
Gas	$ 50	$ 48	$ 51	$ 49	$ 53	$ 45	$ 48	$ 46	$ 43	$ 22	$ 455
Credit Card Payments	$ 50	$ 50	$ 50	$ 50	$ 50	$ -	$ -	$ -	$ -	$ -	$ 250
Total Expenses	***$ 1,040***	***$ 1,043***	***$ 1,026***	***$ 994***	***$ 1,028***	***$ 930***	***$ 923***	***$ 909***	***$ 928***	***$ 829***	***$ 9,650***
NET INCOME (LOSS)	**$ 405**	**$ 447**	**$ 439**	**$ 431**	**$ 372**	**$ (230)**	**$ (223)**	**$ (209)**	**$ 522**	**$ 96**	**$ 2,050**

Problem 2. Assume that the median income for a single person in the debtor's state in the current year is $14,400. Does the debtor satisfy the means test? If so, what is the effect of satisfying the means test? *See* 11 U.S.C. § 707(b)(6) and (b)(7).

Problem 3. Suppose the Debtor's adult son lives with the debtor and pays $300 per month to the Debtor to cover the son's share of rent, food, and other expenses. Should the Debtor's son's payment be included in the calculation of Debtor's current monthly income?

Problem 4. If the Debtor were married, would the Debtor's spouse's income be included in calculating the Debtor's "current monthly income"? How about in determining whether the presumption of abuse applies, or whether a creditor could move for dismissal under the general "abuse" test? Compare 11 U.S.C. §§ 707(b)(6) and 707(b)(7).

3.22. Dismissal for "Abuse" – The Means Test, Part Two

A debtor whose annualized "current monthly income" is above the median income in the debtor's state must run the gauntlet of the means test to avoid having the case dismissed under the means test's presumption of abuse. The gauntlet requires a significant amount of additional calculation.

The calculations start with the same "current monthly income" computed earlier (average prior six months' gross income), but then deduct a series of actual and hypothetical expenses to calculate the debtor's permitted net monthly income. The allowed expenses consist of:

1. The monthly expenses allowed under the Internal Revenue Services' (the "IRS") national and local standards for putting a tax debtor in uncollectable status (11 U.S.C. § 707(b)(2)(A)(ii)(I));
2. Actual monthly expense incurred by the debtor which would be allowed by the IRS as "other necessary expenses" for putting a tax debtor in uncollectable status (11 U.S.C. § 707(b)(2)(A)(ii)(I));
3. Actual expense for providing care and support for an elderly, chronically ill, or disabled family member (11 U.S.C. § 707(b)(2)(A)(ii)(II));
4. Private school tuition for a child under 18 years of age, up to an annual limit currently $1,775 per child (11 U.S.C. § 707(b)(2)(A)(ii)(IV));
5. Reasonable and necessary utilities expenses over the amount allowed by the IRS in the national and local standards (11 U.S.C. § 707(b)(2)(A)(ii)(V)); and most importantly
6. Average contractual secured debt payments over the 60 months following the filing of bankruptcy (11 U.S.C. § 707(b)(2)(A)(iii)(I)).

It is this last deduction that is most controversial, because it allows debtors who have significant car or mortgage debt to satisfy the means test by using their excessive debt incurred to maintain a high standard of living to satisfy the means test. Many believe that debtors with high incomes and excessive secured debts used to maintain a bloated lifestyle are precisely the kinds of debtors who should be forced to trim their luxurious debt-ridden lifestyles and to use their high incomes to repay their unsecured creditors.

A net hypothetical monthly income figure is calculated by reducing "current monthly income" by these allowed expenses. The net monthly income number is then to be multiplied by 60 to compute the amount of net income that the debtor should be able to accumulate over the next five years. The five years of hypothetical net income is then compared with some statutory amounts.

If the Debtor's five years of hypothetical net income is less than $7,025 as of 2014 ($117.09 per month), the debtor will satisfy the means test and there will be no presumption of abuse.

If the Debtor's five years of hypothetical net income is more than $11,725 as of 2014 (195.42 per month), the debtor will fail the means test and the presumption of abuse will apply.

If the debtor's five years of hypothetical net income is less than $11,725 but more than $7,025, then the net income must be compared with 25% of the Debtor's non-priority unsecured claims. If the five years of income is more than 25% of non-priority unsecured claims, the presumption applies; if less than it does not apply. 11 U.S.C. § 707(b)(2).

3.23. Rebutting the Presumption of Abuse under the Means Test

In most cases the presumption of abuse is a death sentence – the case will be dismissed. The presumption can only be rebutted by showing special circumstances for which there were no reasonable alternatives (the examples being military service and serious medical conditions). 11 U.S.C. § 707(b)(2)(B). The debtor must show that the special circumstances were the sole cause of means test failure. *Id.*

3.24. Attorney Sanctions for Means Test Violations

Congress showed special animus towards consumer debtor lawyers by bolstering the general rules for sanctioning an attorney for filing a pleading without evidentiary support. *See* Fed. R. Bankr. Proc. Rule. 9011. Section 707(b)(4)(C) adds a requirement that attorneys perform a **reasonable investigation** into the "circumstances" of the petition, and are deemed to certify that the attorney has no knowledge **after inquiry** that anything in the petition is incorrect. Further, with respect to the means test, debtor attorneys can be sanctioned for the reasonable cost incurred by the United States Trustee in seeking dismissal of cases that do not satisfy the means test, but only if the court determines that the attorney violated Bankruptcy Rule 9011 in signing the petition (known inaccuracies or failing to make proper inquiry). 11 U.S.C. § 707(b)(4)(A). Attorneys must ask the right questions, investigate as red flags answers from clients that do not add up or make sense. But attorneys are not private investigators charged with ferreting out fraud. Attorneys should and generally are not held liable if a client hides assets or files false schedules as long as the attorney asked the right questions and had no reason to suspect the fraud. Attorneys can be held liable for information provided by a client that the client asks the attorney to ignore. Bankruptcy attorneys need to make it clear to their clients that they have special duties of disclosure under the bankruptcy laws that override confidentiality rules. I tell clients "If you tell me something, I have to make sure it's disclosed in your petition if I am going to represent you."

3.24.1. Eligibility after Prior Bankruptcy Cases

Prior bankruptcy cases pose a number of separate problems that are considered in various chapters of this book. As discussed in Chapter 11 (dealing with the discharge), debtors may not be eligible for a discharge in a current case if they received a discharge in another bankruptcy case filed within 2-8 years before the current case was filed. As discussed in Chapter 6 (dealing with

the automatic stay), the automatic stay preventing creditors from foreclosing on property after bankruptcy may automatically terminate in 30 days or never go into effect if one or more bankruptcy cases were previously filed and dismissed within a year before the new bankruptcy case. These provisions do not prevent the filing of a new case *per se*, but may prevent the debtor from receiving the benefits that the debtor expects to receive from filing the new bankruptcy case.

Section 109(g) of the Bankruptcy Code, on the other hand, directly prevents the filing the new case if a previous case was dismissed within 180 days before the filing of the new case if (1) the prior case was dismissed because the debtor failed to comply with court orders or properly prosecute the case, or (2) if the prior case was dismissed after the filing by a creditor of a motion for relief from stay. 11 U.S.C. § 109(g).

The second part of the provision is grossly overbroad and unfair if interpreted as written. The statute assumes that the debtor dismissed the case because of the prior motion for relief from stay, and is abusing the bankruptcy process by filing a second case. But by its terms, section 109(g) would apply even when the dismissal had nothing to do with the motion for relief from stay – indeed even if the motion for relief from stay was denied!

Some courts have mitigated the statutory language to prevent unfairness and hardship by interpreting the statute purposively, where there was no connection between the relief from stay motion and the dismissal. *See* *In re Luna*, 122 B.R. 575 (B.A.P. 9th Cir. Cal. 1991) (denying dismissal when result would be illogical, unintended and unjust); *In re Santana*, 110 B.R. 819 (Bankr. W.D. Mich. 1990) (same). Some courts have read the words "**following** the filing of a request for relief from the automatic stay" to mean that the request for dismissal must be prompted by the relief from stay motion. *In re Duncan*, 182 B.R. 156 (Bankr. W.D. Va. 1995). Most courts require that a proper motion for relief from stay be pending at the time the debtor requests and obtains the voluntary dismissal. *See* *In re Jones*, 99 B.R. 412 (Bankr. E.D. Ark. 1989); *In re Milton*, 82 B.R. 637 (Bankr. S.D. Ga. 1988). In any case, the 180-day refiling rule remains a trap for the unwary that should be carefully considered by a debtor before seeking dismissal of a bankruptcy case.

In cases of extreme abuse involving multiple bankruptcy re-filings, some courts have issued special injunctions prohibiting refiling. These injunctions might not affect the validity of the new case, but should serve as a basis for holding the debtor in contempt of court for violating the injunction.

Chapter 4. The Bankruptcy Estate

There are two fundamental purposes of Chapter 7 of the Bankruptcy Code: (1) to establish an orderly system for liquidating (selling) the debtor's assets to pay creditors' claims, and (2) to provide the debtor with a fresh start by discharging the debtor's pre-bankruptcy debts. In this chapter we begin the study of the process of liquidation and distribution to creditors.

4.1. What Property is in the Estate?

Section 541 of the Bankruptcy Code provides that the filing of bankruptcy automatically creates a new legal entity called the bankruptcy "estate." The estate separates what property is owned by the debtor after bankruptcy from what property is to be sold to pay creditors. Section 541 starts with a broad rule that **everything** owned by the debtor – all legal or equitable interest of the debtor in property – wherever located and by whomever held, as of the date that the bankruptcy case is filed – belongs to the bankruptcy estate. 11 U.S.C. § 541(a). This creates a clear line dividing the property acquired by the debtor after bankruptcy from post-bankruptcy earnings (which belongs to the debtor free of the claims of pre-bankruptcy creditors), and property owned by the debtor on the petition date (which will be used to pay creditors).

However, this broad language disguises many subtleties. To start with, what is "property"? Did the debtor have an "interest" in the "property" on the petition date? If not, the non-property rights belong to the debtor not the bankruptcy estate.

4.2. Cases on Property of the Estate

4.2.1. BOARD OF TRADE OF CHICAGO v. JOHNSON, 264 U.S. 1 (1924)

CHIEF JUSTICE TAFT

Wilson F. Henderson, the bankrupt, a citizen of Chicago, was admitted to membership in the Board of Trade in 1899, and for many months prior to March 1, 1919, was president and one of the principal stockholders in a corporation known as Lipsey and Company, and actively engaged in making contracts on its behalf for present and future delivery of grain on the Board of Trade. In March, 1919, Lipsey and Company became insolvent and ceased to transact business, being then indebted to thirty or more members of the Exchange on its contracts in an aggregate amount of more than $60,000.

The District Court, finding that the [bankrupt's] membership [in the Chicago Board of Trade] was property and under the rules of the Board passed to the trustee in bankruptcy free of all claims of the members, ordered that it be held for transfer and sale for the benefit of the general creditors. [W]as its decree right upon the merits?

[The Board of Trade alleged] that the membership was not property, or capable of being treated as an asset of the bankrupt, that transfer of it had been duly objected to by respondents as members, and that they had adverse claims.

Any male person of good character and credit and of legal age . . . may be admitted to membership in the Board of Trade by ten votes of the Board of Directors, provided that three votes are not cast against him and that he pays an initiation fee of $25,000, . . . signs "an agreement to abide by the Rules, Regulations and By-Laws of the Association." The rules further provide that a member, if he has paid all assessments and has no outstanding claims held against him by members, and the membership is not in any way impaired or forfeited, may, upon payment of a fee of $250, transfer his membership to any person eligible to membership approved by the Board, after ten days posting, both of the proposed transfer and of the name of substitute.

No rule exists giving to the Board of Trade or its members the right to compel sale or other disposition of memberships to pay debts. The only right of one member against another, in securing payment of an obligation, is to prevent the transfer of the membership of the debtor member by filing objection to such transfer with the Directors.

The membership of Henderson was worth $10,500 on January 24, 1920, when the petition in bankruptcy was filed against him. All assessments then due had been paid and the membership was not in any way impaired and forfeited. On May 1, 1919, Henderson had posted on the bulletin of the Exchange a notice and application for a transfer of his membership. . . . [F]ive days after the petition in bankruptcy was filed, members, creditors of Lipsey and Company on its defaulted contracts signed by Henderson, lodged with the Directors objections to the transfer.

Petitioners insist that the membership is not property. The Supreme Court of Illinois, from which State this Board of Trade derives its charter, has held that the membership is not property or subject to judicial sale, basing its conclusion on the ground that it cannot be acquired except upon a vote of ten Directors, and cannot be transferred to another unless the transfer is approved by the same vote, and that it cannot be subjected to the payment of debts of the holder by legal proceedings.

Congress derives its power to enact a bankrupt law from the Federal Constitution, and the construction of it is a federal question. Of course, where the bankrupt law deals with property rights which are regulated by the state law, the federal courts in bankruptcy will follow the state courts; but when the language of Congress indicates a policy requiring a broader construction of the statute than the state decisions would give it, federal courts cannot be concluded by them.

Counsel for petitioners urges that the rules of the associations [do not give the board or its members who are creditors the power to sell the debtor’s membership]. Their only protection is in the power to prevent a transfer as long as the member's obligations to them are unperformed. We do not think this makes a real difference in the character of the property which the member has in his seat. He can transfer it or sell it subject to a right of his creditors to prevent his transfer or sale till he settles with them, a right in some respects similar to the typical lien of the common law.

We think the seat is held by the Board for the bankrupt, and that in bankruptcy the right to dispose of it under the rules passes into the control, and therefore into the possession, of the trustee.

The District Court ordered the transfer and sale of the seat free from all the claims and objections of the petitioners. The view of the court was that . . . the right of the member creditors

to object to the transfer had been lost. We think that the District Court and the Circuit Court of Appeals erred on the merits of the case. The claims of the petitioners amount to more than sixty thousand dollars, and these must be satisfied before the trustee can realize anything on the transfer of the seat for the general estate.

Reversed.

4.2.2. BUTNER v. UNITED STATES, 440 U.S. 48 (1979)

JUSTICE STEVENS

[The] bankruptcy trustee and a second mortgagee [are engaged in a dispute] over [who has] the right to the rents collected during the period between the mortgagor's bankruptcy and the foreclosure sale of the mortgaged property. [We] granted certiorari to decide whether the right to such rents is determined by a federal rule of equity or by the law of the State where the property is located.

[P]etitioner acquired a second mortgage securing an indebtedness of $360,000. Petitioner did not, however, receive any express security interest in the rents earned by the property.

[After a failed attempt at reorganization,] Golden was adjudicated a bankrupt, and the trustee in bankruptcy was appointed. At that time both the first and second mortgages were in default. The trustee was ordered to collect and retain all rents [pending a further order of the bankruptcy court.] [T]he properties were ultimately sold to petitioner by reducing the estate's indebtedness to petitioner from $360,000 to $186,000.

As of the date of sale, a fund of $162,971.32 [in rents from the property] had been accumulated by the trustee. . . . [P]etitioner filed a motion claiming a security interest in this fund and seeking to have it applied to the balance of the second mortgage indebtedness. The bankruptcy judge denied the motion, holding that the $186,000 balance due to petitioner should be treated as a general unsecured claim.

The District Court recognized that under North Carolina law a mortgagor is deemed the owner of the land subject to the mortgage and is entitled to rents and profits, even after default, so long as he retains possession. But the court viewed the appointment of an agent to collect rents during the arrangement proceedings as tantamount to the appointment of a receiver. This appointment, the court concluded, satisfied the state-law requirement of a change of possession giving the mortgagee an interest in the rents; no further action after the adjudication in bankruptcy was required to secure or preserve this interest.

The Court of Appeals reversed. Because petitioner had made no request during the bankruptcy for a sequestration of rents or for the appointment of a receiver, petitioner had not, in the court's view, taken the kind of action North Carolina law required to give the mortgagee a security interest in the rents collected after the bankruptcy adjudication.

We did not grant certiorari to decide whether the Court of Appeals correctly applied North Carolina law. Our concern is with the proper interpretation of the federal statutes governing the administration of bankrupt estates. Specifically, it is our purpose to resolve a conflict between the

Third and Seventh Circuits on the one hand, and the Second, Fourth, Sixth, Eighth, and Ninth Circuits on the other, concerning the proper approach to a dispute of this kind.

The courts in the latter group regard the question whether a security interest in property extends to rents and profits derived from the property as one that should be resolved by reference to state law. In a few States, sometimes referred to as "title States," the mortgagee is automatically entitled to possession of the property, and to a secured interest in the rents. In most States, the mortgagee's right to rents is dependent upon his taking actual or constructive possession of the property by means of a foreclosure, the appointment of a receiver for his benefit, or some similar legal proceeding. Because the applicable law varies from State to State, the results in federal bankruptcy proceedings will also vary under the approach taken by most of the Circuits.

The Third and Seventh Circuits have adopted a federal rule of equity that affords the mortgagee a secured interest in the rents even if state law would not recognize any such interest until after foreclosure. Those courts reason that since the bankruptcy court has the power to deprive the mortgagee of his state-law remedy, equity requires that the right to rents not be dependent on state-court action that may be precluded by federal law. Under this approach, no affirmative steps are required by the mortgagee—in state or federal court—to acquire or maintain a right to the rents.

We agree with the majority view. The constitutional authority of Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States" would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule. Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."

The minority of courts which have rejected state law have not done so because of any congressional command, or because their approach serves any identifiable federal interest. Rather, they have adopted a uniform federal approach to the question of the mortgagee's interest in rents and profits because of their perception of the demands of equity. The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems. But undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt.

In support of their rule, the Third and Seventh Circuits have emphasized that while the mortgagee may pursue various state-law remedies prior to bankruptcy, the adjudication leaves the mortgagee "only such remedies as may be found in a court of bankruptcy in the equitable administration of the bankrupt's assets." It does not follow, however, that "equitable administration" requires that all mortgagees be afforded an automatic security interest in rents and profits when state law would deny such an automatic benefit and require the mortgagee to take

some affirmative action before his rights are recognized. What does follow is that the federal bankruptcy court should take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued. This is the majority view, which we adopt today.

The judgment is affirmed.

4.3. Aftermath – Application to the Bankruptcy Code

The bankruptcy laws have changed since *Board of Trade of Chicago* and *Buttner*, calling into question the actual holdings. Whether the members' hidden liens in *Board of Trade of* Chicago would withstand a trustee's assault under the strong arm powers is a question to be considered later in the course. Similarly, the Bankruptcy Code now contains a specific procedure for creditors like Buttner to perfect their assignment of rents in bankruptcy. If state law requires the creditor to file suit for foreclosure or seek the appointment of a receiver to perfect an assignment of rents, the creditor can perfect the assignment of rents after bankruptcy by filing and serving a simple notice with the bankruptcy court. *See* 11 U.S.C. § 546(b)(2).

However, these classic cases remain crucially important for the twin propositions that (1) federal bankruptcy law defines whether the bundle of rights owned by the debtor on the date of bankruptcy constitutes "property," and (2) in the absence of specific federal legislation state law defines the bundle of rights owned by the debtor on the date of bankruptcy.

4.4. Practice Problems: Property of the Estate

Are the following "property of the estate" under 11 U.S.C. § 541?

Problem 1. Compromising photos (selfies) taken by the debtor (a well-known actress) with her ex-boyfriend.

Problem 2. Life insurance payments received by the debtor 200 days after the death of the debtor's father. 11 U.S.C. § 541(a)(5)(C).

Problem 3. The debtor's dog "fluffie," raised by the debtor since he was a puppy.

Problem 4. The winning lottery ticket purchased by the debtor several days before bankruptcy for a drawing held several days after bankruptcy. 11 U.S.C. § 541(a)(6).

Problem 5. The debtor's winnings on the TV show "the price is right" taped 2 days after bankruptcy. The debtor had been given the ticket to attend the TV show a month before bankruptcy. 11 U.S.C. § 541(a)(6).

Problem 6. Money held in an attorney's trust account, representing the proceeds from the settlement of client cases. 11 U.S.C. § 541(d).

Problem 7. Money held in a spendthrift trust account administered by trustee Bank of New York. The debtor's parents set up the account to provide for the debtor's support. The trust prevents the debtor from wasting the money by providing that the funds in the account could be distributed

by the Bank to the debtor only in an amount which the Bank determined was appropriate based on the debtor's needs. The debtor had no right to withdraw or assign the funds, and the trust provided that the funds were not subject to the claims of the debtor's creditors. Compare 11 U.S.C. § 541(c)(1) and (c)(2).

Problem 8. The debtor's right to royalties earned post-petition from the sale of the debtor's bestselling book "how to make $1,000,000 in the stock market without even trying." *See* 11 U.S.C. § 541(a)(6).

Problem 9. The debtor's interest in a rent controlled residential apartment in New York City. The debtor has lived in the apartment since 1975, pays $300 per month in rent, and the fair rental value is $3,200 per month. The debtor failed to pay rent for the month prior to bankruptcy, the landlord sent a 5 day notice to quit, and the debtor filed bankruptcy 6 days later. *See* 11 U.S.C. § 541(b)(2).

Problem 10. The debtor's right to receive a tax refund for the 2014 calendar tax year if the debtor filed bankruptcy in 2015.

Problem 11. The debtor's right to receive a tax refund for the 2014 calendar year if the debtor filed bankruptcy in November 2014.

4.5. Cases on Mixed Prepetition and Post-Petition Earnings as Property of the Estate

4.5.1. IN RE BAGEN, 186 B.R. 824 (Bankr. S.D.N.Y. 1995)

[Debtor] Gregory W. Bagen ("Bagen"), and his wife filed a joint petition for bankruptcy relief under Chapter 7 . . . on October 22, 1992. At the time of the bankruptcy filing, Bagen was the attorney of record for various plaintiffs in personal injury actions pending in state courts. His prepetition retainer agreements provided for payment of attorney's fees to him contingent upon settlement of or recovery in those actions. At the commencement of his bankruptcy case, the personal injury actions were in various stages of litigation, from initial discovery to appeal.

The Chapter 7 Trustee seeks to apportion and recover for this estate only those attorney's fees earned prepetition (i.e., fees attributable to Bagen's prepetition services) and paid or to be paid postpetition.

Bagen advances two arguments: (1) the Second Circuit Court of Appeals has held, albeit under the former Bankruptcy Act, that a debtor/attorney's contingent right to payment of fees is not property of the bankruptcy estate; and (2) case law under the Code supports the proposition that fees received postpetition, and attributable to prepetition contingent contracts, are not property of the bankruptcy estate if all acts necessary to earn those fees were not completed prepetition.

Pursuant to retainer agreements with his clients, Bagen is to receive payment only if the condition precedent — successful resolution of the prepetition personal injury claims — occurs. The issue, therefore, is whether a prepetition contingent contract right to payment is property of the bankruptcy estate even though the debtor is entitled to nothing unless and until the condition precedent occurs?

In *In re Coleman*, 87 F.2d 753 (2d Cir. 1937), the Second Circuit Court of Appeals held that the fee earned under a bankrupt/attorney's prepetition contingent-fee contract, which had not resulted in a fund as of the petition date, was not property of the bankruptcy estate within the meaning of section 70 of the Bankruptcy Act. The Second Circuit Court of Appeals conclude[ed] that under New York State common law, an attorney would have no rights under a contingent-fee contract until the "services were fully performed and a fund was created." Section 475 of the New York Judiciary Law created a "new remedy," which does not give an attorney the right "to compensation unless and until a fund was created by a judgment or settlement." Thus, the remedy created by the New York Judiciary Law was not property or a property right on the date bankruptcy was filed. Moreover, the Coleman court noted that for an asset to be considered property of the estate under section 70 [of the Bankruptcy Act], the asset must have a "calculable value." It concluded that since there was no fund at the time the bankruptcy petition was filed, "[t]he services performed [by the attorney] were then without property value within section 70 and might very well have gone altogether uncompensated."

With the passage of the Code, Congress substantially broadened the scope of property of the estate. According to the legislative history "The bill determines what is property of the estate by a simple reference to what interests in property the debtor has at the commencement of the case. This includes all interests, such as interests in real or personal property, tangible and intangible property, choses in action, causes of action, rights such as copyrights, trade-marks, patents, and processes, contingent interests and future interests, whether or not transferable by the debtor."

As the legislative history to section 541 indicates, Congress intended property of the estate to include all interests of a debtor, including a debtor's contract right to future, contingent property. Thus, the *Coleman* conclusion that section 475 of the New York Judiciary Law did not create a property right under the former Act does not preclude a finding that property of the estate under the Code includes a debtor's contingent, contractual right to postpetition property.

In *In re Sloan*, 32 B.R. 607 (Bankr.E.D.N.Y.1983), the Chapter 7 trustee sought to include as property of the estate a finder's fee received by the debtor postpetition. The court concluded that "[t]he decisive factor in determining whether postpetition income of the debtor will be deemed property of the estate is whether that income accrues from post-petition services of the debtor." It noted that postpetition income will be property of the estate only when "all the acts of the debtor necessary to earn it are rooted in the pre-bankruptcy past." Thus, the court held that since the debtor was not required to perform additional services postpetition, the finder's fee paid postpetition was property of the bankruptcy estate.

In concluding that the finder's fee was property of the bankruptcy estate, the court distinguished *In re Coleman:* "Not only was *Coleman* decided under more stringent standards of the former Bankruptcy Act, . . . but it involved a situation in which the bankrupt continued to perform services under his contingency fee. According to *Sloan*, the Trustee would be barred from recovering anything under Bagen's prepetition contingent-fee contracts because of Bagen's obligation to perform post-petition services under those contracts.

I respectfully disagree with that analysis. A debtor's continuing obligation to perform postpetition services . . . should not prevent the debtor's contingent contract right to future payment from becoming part of the bankruptcy estate. Although a right to payment may depend and be conditioned upon future performance, that right, nevertheless, may be property of the bankruptcy

estate. By defining the term "property of the estate" broadly, Congress intended to encompass contingent future payments that were subject to a condition precedent on the date of bankruptcy. Accordingly, those portions of Bagen's contingent attorney's fees which may be paid postpetition, but were nevertheless earned and rooted in his prepetition past, should be includable in his bankruptcy estate.

Bagen's prepetition contingent contractual right to postpetition property is property of the estate pursuant to Code section 541(a)(1). Any postpetition payment made under the prepetition contingent-fee contracts is property of this estate to the extent earned prepetition. The estate's interest in the future payment includes the entire sum paid less the amount attributable to services rendered postpetition.

The fact that a debtor must continue to perform services after bankruptcy (as a condition precedent to payment) does not preclude a finding that the bankruptcy estate has an interest in the contingent contract right to future payment. (Valuation of this interest is not before me on this motion.) Accordingly, the Debtor's Motion to Dismiss Trustee's Complaint is denied.

4.5.2. TOWERS v. WU, 173 B.R. 411 (9th Cir. BAP 1994)

The debtor, Sophia C.Y. Wu, has been employed as a "career agent" by State Mutual Life Assurance Company of America since 1983. As a career agent for State Mutual, the debtor is responsible for selling insurance and annuity policies. Section 12 of the Career Agent Agreement obligates State Mutual to pay to the debtor while the agreement is in force, commissions on first year and renewal premiums paid to State Mutual on insurance and annuity policies sold by the debtor.

The debtor filed a Chapter 7 petition on March 29, 1991. From the commencement of the bankruptcy case through August 31, 1992, State Mutual paid the debtor $50,472.56 in renewal commissions for policies sold prepetition.

The Chapter 7 trustee, Edward F. Towers, filed an adversary proceeding seeking to avoid the payment of the postpetition renewal commissions under section 549(a) and to recover the value of these payments under section 550(a). On cross-motions for summary judgment, the bankruptcy court determined that the renewal commissions were not property of the estate because the payment of the commissions depended upon postpetition services by the debtor and the commission payment structure adopted by the Career Agent Agreement reflects that the renewal commissions are allocated to services performed postpetition. The trustee filed this timely appeal from the order denying his motion for summary judgment and granting the debtor's motion for summary judgment.

Section 541(a)(6) provides that the bankruptcy estate includes the "[p]roceeds, product, offspring, rents, and or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case." This case requires us to determine whether the postpetition renewal commissions are included within the scope of the postpetition earnings exception contained in section 541(a)(6).

While the Ninth Circuit has not addressed the question of postpetition renewal commissions, it has addressed section 541(a)(6) in situations involving postpetition earnings that

arise, at least in part, out of prepetition services or prepetition property. In *In re FitzSimmons*, 725 F.2d 1208 (9th Cir.1984), the court determined that while the earnings exception of section 541(a)(6) applied in the Chapter 11 case of a debtor engaged in a law practice as a sole proprietor, it did not remove all of the postpetition earnings of the law practice from the estate. The court held that the earnings exception applies only to the earnings generated by services personally performed by the individual debtor postpetition. To the extent postpetition earnings are not attributable to such personal services but to the business' invested capital, accounts receivable, goodwill, employment contracts with the firm's staff, client relationships, fee agreements, or the like, the earnings are property of the estate.

Several courts in other jurisdictions have specifically addressed whether postpetition renewal commissions are property of the estate. In order to determine this question, these courts have generally focused upon the rights and obligations of the debtor pursuant to the employment agreement and whether the receipt of the commissions was dependent upon the performance of postpetition services. Where a debtor's postpetition services were not necessary to generate the renewal commissions, courts have found the renewal commissions to be property of the estate. Where, however, the contract required a debtor to remain employed by the insurer and to service the existing policies or perform certain other services in order to receive the renewal commissions, courts have found that postpetition services were necessary to generate the renewal commissions and the commissions were not property of the estate.

The opinions addressing the renewal commissions are helpful in analyzing whether postpetition services are necessary for renewal commissions under a given contract. These cases, however, make the entire analysis turn upon the presence of a requirement of postpetition services. Under these cases, if there is such a requirement, all of the renewal commissions will be excluded from the estate. If there is not such a requirement, then all renewal commissions will be included in the estate.

This all or nothing approach is inconsistent with *FitzSimmons* which caution[s] us to determine the extent to which the earnings are attributable to prepetition property or prepetition services. The proper analysis is to first determine whether any postpetition services are necessary to obtaining the payments at issue. If not, the payments are entirely "rooted in the pre-bankruptcy past," and the payments will be included in the estate. If some postpetition services are necessary, then courts must determine the extent to which the payments are attributable to the postpetition services and the extent to which the payments are attributable to prepetition services. That portion of the payments allocable to postpetition services will not be property of the estate. That portion of the payments allocable to prepetition services or property will be property of the estate.

In this case, the bankruptcy court essentially followed this analysis. It determined that because the contract required that the debtor remain employed and provide a fixed amount of new business in order to receive renewal commissions, postpetition services are required. The court then determined that, although it is difficult to allocate the renewal commissions to prepetition or postpetition efforts, the manner in which the contracts in question provide for most of the commission to be paid in the initial year of the policy and a much smaller percentage to be paid in subsequent years reflects an allocation of the renewal commissions to the postpetition services required to generate renewals.

[The Court then discusses whether post-petition services were required to receive the renewal commissions, and determined that the question is not clear.] We determine that there is a disputed factual issue as to whether the debtor's postpetition efforts are required for the receipt of the renewal commissions. If postpetition services are required, there is also a disputed issue of material fact— to what extent are the earnings properly allocable to postpetition and/or prepetition efforts of the debtor.

4.5.3. SHARP v. DERY, 253 B.R. 204 (E.D. Mich. 2000)

Debtor filed a Chapter 7 petition on December 21, 1998. At that time through February, 1999, Valasis Communications, Inc. employed Debtor. On February 22, 1999, Debtor received an employee bonus of $11,331.63. The bonus plan was based upon a fiscal year of January 1 to December 31. To receive the bonus under the plan, a worker must have been employed in good standing when the company issued the bonus checks; i.e., he must not have been fired or resigned during the plan year or before issuance of the dividend. An exception existed for employees who retired, were disabled, or died during the fiscal year. In those cases, the plan administrator may have, at his discretion, issued the employee a pro rata dividend.

The employer had the right to amend, suspend, or terminate the bonus plan at any time. The timing of any bonus checks under the plan also was at the employer's sole discretion.

Debtor did not disclose that he would receive a bonus when he filed his bankruptcy petition and schedules. At the § 341 meeting, which was held just before Debtor received the bonus on February 22, 1999, Debtor stated that the bonus's value would be lower than it ultimately was. Partly because of these factors, Debtor failed to qualify for a discharge under § 727 of the Bankruptcy Code.

Trustee sought a determination from the bankruptcy court that the post-petition bonus was property of the estate. The bankruptcy court decided that it was, and ordered Debtor to turn over the post-petition bonus to Trustee. Trustee is now holding those funds in escrow pending the outcome of this appeal.

The determinative issue in this case, therefore, is whether Debtor had an enforceable right to receive the bonus check when he filed his petition, December 21, 1998. The court below thus reasoned that, because the employer had no discretion as to the amount and timing of any bonus that it decided to pay, Debtor had a right to the bonus as of December 21, and that bonus was therefore the estate's property.

The bankruptcy court misconstrued the significance of the above fact. Although the employer may have had no discretion over the amount of any bonus that it actually paid Debtor, as both parties agree, the bonus plan's terms gave the employer discretion as to whether it would pay any bonus at all.

The bonus plan in this case requires that "an employee must be currently employed in good standing." It is hard to imagine how an employer [employee?] who does not "satisfactorily perform his job" could be "employed in good standing." Even if there were a difference between those two terms, however, the bonus plan at bar [has the following] dispositive characteristic: the employer, as of the date the debtor filed for bankruptcy, could have decided not to pay any bonus at all under

the terms of the bonus plan itself. [Under Michigan law] an employee who ends his employment before the closing date of a bonus period, thereby failing to establish a contractually-mandated condition for receipt of the bonus, forfeits eligibility for the bonus dividend. As of December 21, therefore, Debtor would have had no legally-recognized interests in the bonus check he later received on February 22.

When post-petition income "is dependent upon the continued services of the debtor subsequent to the petition, the amounts do not constitute property of the estate."

The post-petition services that a debtor need perform in order to trigger this rule are, moreover, exceedingly slight. In *Matter of Haynes*, 679 F.2d 718 (7th Cir.1982), for example, the Seventh Circuit held that the pay of a military retiree was not part of the bankruptcy estate, because it was conditioned on his obligation to perform certain military duties if called upon to do so. The *Haynes* court cited no example of the debtor ever actually having had to perform such an obligation. It merely reasoned that because the debtor "remained subject to the Uniform Code of Military Justice ... and could be recalled to active duty" in an emergency, his retirement pay was dependent upon continued services subsequent to the petition, and thus did not constitute property of the estate.

In this case, Debtor had to labor for his employer more than two months after the date of filing in order to be eligible for his bonus pay. [I]t is apparent that his bonus check was "dependent upon the continued services of the debtor subsequent to the petition," such that it does "not constitute property of the estate."

Attempting to refute this conclusion, Trustee cites *Towers v. Wu*, 173 B.R. 411 (9th Cir. BAP 1994) for the proposition that the bonus check "will constitute property of the estate if it is sufficiently rooted in pre-petition activities." Trustee argues that the rationale of Wu would lead the Court to apportion the bonus between the parts that Debtor earned pre-petition and post-petition, the former going to Trustee and the latter to Debtor. The Court rejects this argument for three reasons.

First, apportionment would be contrary to the plain language of § 541. That statute, in pertinent part, dictates that only "legal or equitable interests of the debtor in property as of the commencement of the case" are included in the bankruptcy estate. 11 U.S.C. § 541(a)(1). Regardless of how rooted Debtor's bonus might have been in prepetition activities, he had, for reasons discussed above, no "legal or equitable interests" in that dividend when the case began on December 21, 1998. Under the clear language of the statute, therefore, the Court cannot apportion any part of that bonus dividend to the estate.

Even if the text were unclear, legislative history would provide a second reason for this Court's conclusion. As both the House of Representatives and Senate Reports make plain, § 541 "is not intended to expand the debtor's rights against others more than they exist at the commencement of the case." A trustee, moreover, "could take no greater rights than the debtor himself had" on the day of filing the bankruptcy petition. The Court, accordingly, may apportion no part of the bonus plan to pre-petition services and allot that portion to the estate.

The third reason that this Court decides it cannot apportion the part of Debtor's bonus attributable to his pre-petition services to the estate is that the chief decisions upon which the Wu court relied are consistent with such a holding. . . . Thus did the Ninth Circuit gives its imprimatur to apportionment, but only to the extent that it would allocate funds to the estate in which the

debtor had cognizable rights as of the petition date. Here, Debtor had no discernible right to his bonus check as of the petition date.

The plain text of § 541(a)(1) does not allow for apportionment, and apportionment would be contrary to Congress's intent. What authority there is to the contrary, moreover, is unpersuasive. The Court may not, therefore, apportion Debtor's bonus dividend.

REVERSED. Trustee will transfer the $11,331.63 in bonus-dividend funds that it holds in escrow to Debtor within seven days of receipt of this order.

Chapter 5. Exemptions

This chapter follows what may have appeared to be a pretty bleak picture for debtors seeking bankruptcy protection. In the last chapter we learned that debtors must turn over to the trustee all of their property, which becomes property of the estate, for liquidation. That picture is not accurate, however, because an **individual** debtor is allowed to remove from the property of the estate, and keep, any property that is **exempt**. 11 U.S.C. § 522(b)(1). Determining what property is exempt is therefore extremely important to the individual Chapter 7 debtor.

While the statute suggests that the debtor recovers exempt property from the estate after turning over all property, in practice the debtor simply does not turn over to the trustee the exempt property. Instead, the debtor turns over to the trustee only that property which is not exempt.

Exemptions are not directly relevant to the reorganization chapters because an individual debtor is allowed to keep **all** of his or her property in reorganization, regardless of whether the property is exempt or not. However, the exemptions come into play indirectly in reorganization cases as well, because the individual debtor must show that creditors will receive more in present value under the reorganization plan than they would receive in Chapter 7 liquidation. Thus, the reorganizing debtor does not have to "pay" out of future earnings for property that would be exempt in Chapter 7.

Note that entity debtors, such as corporations and partnerships, are not entitled to exemptions. 11 U.S.C. § 522(b)(1), emphasis added ("an **individual** debtor may exempt from property of the estate . . ."). All property owned by corporate debtors becomes property of the estate. A corporate debtor in Chapter 7 has no post-petition earnings that are separate from the bankruptcy estate since the corporation is nothing more than the property it owns, and therefore all corporate post-petition earnings must have grown out of the bankruptcy estate. *See* 11 U.S.C. § 541(a)(6) (property of the estate includes all post-petition earnings from property of the estate). The corporate debtor after a Chapter 7 liquidation has been completed is an asset-less shell that has no ability to continue in business. Chapter 7 is corporate death (although the process for terminating the corporation's legal status under state law should be followed). An individual human debtor, however, lives on, keeping his or her exempt property and all post-petition earnings from the individual debtor's labor.

There are two separate exemption schemes recognized in bankruptcy: (1) a federal exemption scheme in section 522(d) of the Bankruptcy Code, and (2) the applicable non-bankruptcy exemption scheme in the debtor's applicable state (which is used under state law to prevent judgment creditors from levying the debtor's exempt property), plus any non-bankruptcy federal exemptions that are available to the debtor.

The Bankruptcy Code allows the debtor to elect to use either the Bankruptcy Code's exemptions, or the applicable state exemptions plus the non-bankruptcy federal exemptions, **unless** the debtor's applicable state as "opted out" – by prohibiting its debtors from using the federal bankruptcy exemptions. 11 U.S.C. § 522(b). In "opt out" states, the debtor must use the state exemptions (together with non-bankruptcy federal exemptions).

The first step in analyzing exemptions is to determine which state's exemption laws are applicable to the debtor. In order to discourage debtors from moving between states in an attempt

to utilize more favorable exemptions, the Bankruptcy Code looks at two time periods in determining which state's exemption laws apply.

First, if a debtor has been domiciled (resided) in a single state continuously for the 730 days (2 years) before filing bankruptcy, the debtor will use that state's exemption laws. 11 U.S.C. § 522(b)(3)(A).

Second, if the debtor has not been domiciled in a single state continuously for 730 (2 years) before bankruptcy, then the applicable period is the 180 days (6 mos) before the 730 day period. In that case, the question becomes "in what state was the debtor domiciled **the most** during the 180 day period." *Id*.

5.1. Practice Problems: Which State's Exemptions Apply?

Read 11 U.S.C. § 522(b)(3)(A), and answer the following questions:

Problem 1. Debtor was born and lived in Georgia for 50 years before deciding that he needed to file bankruptcy. After visiting a local bankruptcy lawyer, debtor learned that the exemption laws in the State of Florida are much more generous to him than the exemption laws in the State of Georgia. On the advice of his attorney, debtor moved to Florida, waited two years and two days, and then filed bankruptcy in Florida, claiming the Florida exemptions. Is he eligible for the Florida exemptions?

Problem 2. Suppose that the debtor in Problem (1), after living in Florida for only 100 days, received a good job offer in North Dakota, and decided to move. If the debtor wants to use Florida's exemptions (rather than Georgia's or North Dakota's), what is the shortest amount of time he should wait after moving to North Dakota before filing his bankruptcy petition?

5.2. Electing the State or Federal Exemption Scheme

Debtors subject to the exemption laws of a state that has opted out by precluding its debtors from electing the federal bankruptcy exemptions must use the state's exemption scheme. 11 U.S.C. § 522(b)(1). About two thirds of the states have opted out (as of this writing, 19 states allow the election between the state and federal exemptions).

The exemptions provided by state law vary greatly across the county. Some states have extremely generous exemptions (such as Florida and Texas, allowing debtors to exempt an unlimited amount of equity in a home), while others states are rather miserly (no homestead in New Jersey and Pennsylvania). Most states exempt the basics: clothing, household goods, a few thousand dollars of equity in a car, tools of the trade, and the like. State exemption statutes were drafted primarily to protect the debtor's necessary property from the claims of unsecured judgment creditors. Both in and out of bankruptcy, **exemptions do not protect against consensual liens**. It is the value of the property in excess of any consensual liens, the debtor's equity in the property, that is subject to exemption.

The federal bankruptcy exemptions are set forth in 11 U.S.C. § 522(d). Most debtors who are allowed to elect, and do not have a lot of home equity, are better off using the federal

exemptions rather than the state exemptions because of the so-called "wild card," 11 U.S.C. 522(d)(5), which allows a debtor who does not claim a homestead exemption to exempt nearly $12,000 of "any property," which includes cash, tax refunds, and property having a value exceeding the limited exemption amounts otherwise available.

State homestead exemptions are often larger than the federal homestead exemption – often significantly larger. If the debtor has a large amount of equity in a home, and the state allows a large homestead exemption, then the debtor may be better off using the state exemptions even at the cost of giving up the federal wild card exemption. Also, the federal exemptions are not available in states that have opted out of the federal scheme. Choosing exemptions is thus a complex matter of determining whether both the federal and state schemes are available to the debtor, and then evaluating whether the debtor is better off under the federal or state scheme.

It is important to remember that exemptions do not free the debtor's property from liens. 11 U.S.C. § 522(c). What is exempted is the debtor's equity in the property (the value of the property in excess of liens). However, as is discussed below in Section 5.7, two kinds of liens can be avoided if they impair exemptions: (1) judicial liens, and (2) non-possessory, non-purchase money liens on household goods. 11 U.S.C. § 522(f). Avoidance is not automatic – the debtor must file a separate adversary proceeding to avoid the liens.

Valuing property for exemption purposes is a complex and confusing issue. The Bankruptcy Code requires the use of "fair market value," a term that is not defined in the Bankruptcy Code. 11 U.S.C. § 522(a)(2). In the business world, fair market value is the price a willing buyer would pay a willing seller with full information and neither under compulsion. It is always a hypothetical value because there is no market transaction taking place. One thing is clear, it is the "fair market value" of the property **in its current condition** – not the value of the property when new.

A purposive approach to valuation would require the court to determine the amount that the trustee could receive from the sale of the property, which may well be lower than the traditional measure of fair market value. The purpose of the exemptions is to determine whether the trustee can sell the property and use the proceeds above the exemption amount to pay creditors. The debtor would have to receive the exempt amount from the sale, and the estate would get the benefit of the proceeds over the exempt amount. Some courts have accepted this purposive approach, while others have rejected it. Compare *In re Walsh*, 5 B.R. 239 (Bankr. D.C. 1980) (use of "liquidation value" appropriate), and *In re Sumerell*, 194 B.R. 818 (Bankr. D.D. Tenn. 1996) (liquidation value inconsistent with fair market value).

It is not clear what would happen in those jurisdictions that have rejected the trustee resale value approach. For example, assume the debtor has a diamond ring that is exempt in the amount of $1,550 under 11 U.S.C. § 522(d)(4). Assume that the bankruptcy court has determined that the ring has a "fair market value" of $1,800, but the trustee is only able to sell it for $1,400. If the trustee were allowed to sell it for less than the exemption amount on the basis of the court's valuation, the debtor would be deprived of the full value of the exemption, which would not serve the purpose of the exemption statute. On the other hand, if the trustee were able to sell it for $1,600, then the Debtor would receive the $1,550 exemption amount and the trustee would keep the remaining $50 to pay creditors – serving the purpose of the statute. Using a value different from the amount the trustee could recover does not work in practice to preserve the debtor's exemption.

As we will discuss later, a different question arises in the reorganization chapters when the court is valuing property to determine the portion of a claim that is secured under Section 506 of the Bankruptcy Code. As will be discussed later, valuation serves a very different purpose under the reorganization chapters than it does under the exemption statutes. The proper measure of value for exemption purposes is the value that the trustee would receive from an orderly sale of the property.

5.3. Practice Problems: The Federal Exemptions

Problem 1. Debtors (husband and wife filing jointly) own the following property. What can be exempted under Section 522(d) of the Bankruptcy Code?

a. The mobile home that the debtors live in (costing $30,000, but currently worth $6,000). The mobile home sits on a 100 acre farm worth $24,000;
b. A John Deere tractor worth about $7,000;
c. Furniture (couch, chairs, beds, dressers and the like) costing $4,000, but currently worth very little, maybe $500. But the debtors also own a 200 year old antique dining table inherited years ago from the husband's grandmother worth $3,000;
d. Clothing costing $800, worth very little;
e. The debtors' champion Siamese show cat purchased as a kitten for $1,000 now worth $2,500;
f. The wife's diamond wedding ring, costing $3,000, and having an appraised insurance value of $2,800. Debtors took the ring to a local jewelry store/pawn shop, and were offered only $400 for the ring.
g. $5,400 in the debtor's checking account, and $300 in the debtor's cash jar.
h. Debtor's farming tools costing $7,000 and having a liquidation value of $500;
i. Two 50 inch plasma flat screen TVs, one in the living room and one in the bedroom. Each cost $3,000 new, but the current liquidation value is $400 each. *See* 11 U.S.C. § 522(f)(4)(A).
j. $250,000 in the debtor wife's retirement account at work.

Problem 2. If your client rolled over a $1,400,000 company retirement account (401(k)) into an IRA after losing her job, will her exemption be limited? *See* 11 U.S.C. § 522(n).

Problem 3. Debtor filed bankruptcy in New York on December 31, 2014. Debtor lived in Tennessee from January 2010-December 31, 2013, and in New York from December 31, 2013 to December 31, 2014. Debtor sold his house in Tennessee on December 20, 2013 for $250,000, paid off the $200,000 mortgage, and invested the $50,000 balance in a new home in Syracuse, New York. The new home cost $200,000, and the debtor borrowed $150,000 from a bank to make the purchase. The bank currently holds a mortgage with a loan balance of $140,000, and the house is worth $250,000. New York allows a $75,000 homestead exemption for property owned in New York, and Tennessee allows a $75,000 homestead exemption for property owned in Tennessee. Assume that Tennessee has opted out of the federal exemptions. Can the debtor claim a homestead exemption on the New York home, and if so in what amount?

NOTE: The cases on this dealing with this question are all over the map. Some courts say a former state's exemptions always apply to a new state (even if restricted in the state's exemption statute), while other courts restrict a state's exemptions to its own state even if the statute is silent about where the exemptions apply. Compare *In re Drenttel*, 403 F.3d 611 (8th Cir. 2005) (applying old states exemptions in new state where old state's statute does not specifically limit exemptions to property held in state); *In re Tanzi*, 287 B.R. 557 (Bankr. W.D. Wash. 2002) (debtor could use either Washington or California exemptions on Florida residence), and *In re Stratton*, 269 B.R. 716 (Bankr. D. Or. 2001) (Oregon homestead exemption could be used for California property) with *In re Sipka*, 149 B.R. 181 (D. Kan. 1992) (cannot use Kansas homestead exemptions after moving to Michigan), and *In re Peters*, 91 B.R. 401 (Bankr. W.D. Tex. 1988) (Texas homestead exemption, which was limited by statute to homesteads in Texas, cannot be used to exempt an out-of-state residence). In the states that interpret the old states' statutes not to apply in the new state, the debtor is generally entitled to use the federal exemptions even if the old state opted out of the federal exemptions. *See* flush language following 11 U.S.C. § 522(b)(3).

5.4. Cases on the Allowance of Exemptions

5.4.1. TAYLOR v. FREELAND & KOONZ, 503 U.S. 638 (1992)

JUSTICE THOMAS delivered the opinion of the Court.

Section 522(l) of the Bankruptcy Code requires a debtor to file a list of the property that the debtor claims as statutorily exempt from distribution to creditors. Federal Rule of Bankruptcy Procedure 4003 affords creditors and the bankruptcy trustee 30 days to object to claimed exemptions. We must decide in this case whether the trustee may contest the validity of an exemption after the 30-day period if the debtor had no colorable basis for claiming the exemption.

The debtor in this case, Emily Davis, declared bankruptcy while she was pursuing an employment discrimination claim in the state courts. Davis alleged that her employer, Trans World Airlines (TWA), had denied her promotions on the basis of her race and sex. In October 1984, Davis filed a Chapter 7 bankruptcy petition, and petitioner Robert J. Taylor, became the trustee of Davis' bankruptcy estate. On a schedule filed with the Bankruptcy Court, Davis claimed as exempt property the money that she expected to win in her discrimination suit against TWA. She described this property as "Proceeds from lawsuit—[Davis] v. TWA" and "Claim for lost wages" and **listed its value as "unknown**." [emphasis added]

Taylor decided not to object to the claimed exemption. The record reveals that Taylor doubted that the lawsuit had any value. Taylor at one point explained: "I have had past experience in examining debtors . . . [.] [M]any of them . . . indicate they have potential lawsuits. . . . [M]any of them do not turn out to be advantageous and . . . many of them might wind up settling far within the exemption limitation." Taylor also said that he thought Davis' discrimination claim against TWA might be a "nullity."

Taylor proved mistaken. In October 1986, the Pennsylvania Supreme Court affirmed the Commonwealth Court's determination that TWA had discriminated against Davis. In a subsequent settlement of the issue of damages, TWA agreed to pay Davis a total of $110,000. Upon learning of the settlement, Taylor filed a complaint against respondents in the Bankruptcy Court. He demanded that respondents turn over the money that they had received from Davis because he considered it property of Davis' bankruptcy estate. Respondents argued that they could keep the fees because Davis had claimed the proceeds of the lawsuit as exempt.

[Bankruptcy Rule 4003(b) provides:] "The trustee or any creditor may file objections to the list of property claimed as exempt within 30 days after the conclusion of the meeting of creditors held pursuant to Rule 2003(a) . . . unless, within such period, further time is granted by the court."

The parties agree that Davis did not have a right to exempt more than a small portion of these proceeds either under state law or under the federal exemptions specified in § 522(d). Davis in fact claimed the full amount as exempt. Taylor, as a result, apparently could have made a valid objection under § 522(l) and Rule 4003 if he had acted promptly. We hold, however, that his failure to do so prevents him from challenging the validity of the exemption now.

Taylor argues that his failure to object does not preclude him from challenging the exemption after expiration of the 30-day period if the debtor did not have a good-faith or reasonably disputable basis for claiming it. In this case, Taylor asserts, Davis did not have a colorable basis for claiming all of the lawsuit proceeds as exempt and thus lacked good faith.

We reject Taylor's argument. Deadlines may lead to unwelcome results, but they prompt parties to act and they produce finality. In this case, despite what respondents repeatedly told him, Taylor did not object to the claimed exemption. If Taylor did not know the value of the potential proceeds of the lawsuit, he could have sought a hearing on the issue, see Rule 4003(c), or he could have asked the Bankruptcy Court for an extension of time to object, see Rule 4003(b). Having done neither, Taylor cannot now seek to deprive Davis and respondents of the exemption.

Taylor suggests that our holding will create improper incentives. This concern, however, does not cause us to alter our interpretation of § 522(l). Debtors and their attorneys face penalties under various provisions for engaging in improper conduct in bankruptcy proceedings. See, e. g., 11 U.S.C. § 727(a)(4)(B) (authorizing denial of discharge for presenting fraudulent claims); Rule 1008 (requiring filings to "be verified or contain an unsworn declaration" of truthfulness under penalty of perjury); Rule 9011 (authorizing sanctions for signing certain documents not "well grounded in fact and . . . warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law"); 18 U.S.C. § 152 (imposing criminal penalties for fraud in bankruptcy cases). These provisions may limit bad-faith claims of exemptions by debtors. To the extent that they do not, Congress may enact comparable provisions to address the difficulties that Taylor predicts will follow our decision. We have no authority to limit the application of § 522(l) to exemptions claimed in good faith.

5.4.2. SCHWAB v. REILLY, 560 U.S. 770, 130 S.Ct. 2652 (2010)

JUSTICE THOMAS delivered the opinion of the Court.

This case presents an opportunity for us to resolve a disagreement among the Courts of Appeals about what constitutes a claim of exemption to which an interested party must object under § 522(l). The issue is whether an interested party must object to a claimed exemption where, as here, the Code defines the property the debtor is authorized to exempt as an interest, the value of which may not exceed a certain dollar amount, in a particular type of asset, and the debtor's schedule of exempt property accurately describes the asset and declares the "value of [the] claimed exemption" in that asset to be an amount within the limits that the Code prescribes. We hold that, in cases such as this, an interested party need not object to an exemption claimed in this manner in order to preserve the estate's ability to recover value in the asset beyond the dollar value the debtor expressly declared exempt.

Respondent Nadejda Reilly filed for Chapter 7 bankruptcy when her catering business failed. The assets Reilly listed on Schedule B included an itemized list of cooking and other kitchen equipment that she described as "business equipment," and to which she assigned an estimated market value of $10,718.

On Schedule C, Reilly claimed two exempt interests in this equipment pursuant to different sections of the Code. Reilly claimed a "tool[s] of the trade" exemption of $1,850 in the equipment under § 522(d)(6), and she claimed a miscellaneous exemption of $8,868 in the equipment under § 522(d)(5), which, at the time she filed for bankruptcy, permitted a debtor to take a "wildcard" exemption equal to the "debtor's aggregate interest in any property, not to exceed" $10,225 "in value. The total value of these claimed exemptions ($10,718) equaled the value Reilly separately listed on Schedules B and C as the equipment's estimated market value.

Subject to exceptions not relevant here, the Federal Rules of Bankruptcy Procedure require interested parties to object to a debtor's claimed exemptions within 30 days after the conclusion of the creditors' meeting held pursuant to Rule 2003(a). If an interested party fails to object within the time allowed, a claimed exemption will exclude the subject property from the estate even if the exemption's value exceeds what the Code permits. See *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992).

Petitioner William G. Schwab, the trustee of Reilly's bankruptcy estate, did not object to Reilly's claimed exemptions in her business equipment because the dollar value Reilly assigned each exemption fell within the limits that §§ 522(d)(5) and (6) prescribe. But because an appraisal revealed that the total market value of Reilly's business equipment could be as much as $17,200, Schwab moved the Bankruptcy Court for permission to auction the equipment so Reilly could receive the $10,718 she claimed as exempt, and the estate could distribute the equipment's remaining value (approximately $6,500) to Reilly's creditors.

Reilly opposed Schwab's motion. She argued that she had put Schwab and her creditors on notice that she intended to exempt the equipment's full value, even if that amount turned out to be more than the dollar amount she declared, and more than the Code allowed. [The Bankruptcy Court and] the Court of Appeals agreed that by equating on Schedule C the total value of her exemptions in her business equipment with the equipment's market value, Reilly "indicate[d] the intent" to exempt the equipment's full value. In reaching this conclusion, the Court of Appeals relied on our

decision in Taylor: "`[A]n unstated premise' of Taylor was `that a debtor who exempts the entire reported value of an asset is claiming the "full amount," whatever it turns out to be.'"

We conclude that the Court of Appeals' approach fails to account for the text of the relevant Code provisions and misinterprets our decision in *Taylor*. Accordingly, we reverse.

The portion of § 522(l) that resolves this case is not, as Reilly asserts, the provision stating that the "property claimed as exempt on [Schedule C] is exempt" unless an interested party objects. Rather, it is the portion of § 522(l) that defines the target of the objection, namely, the portion that says Schwab has a duty to object to the "list of property that the debtor claims as exempt under subsection (b)." (Emphasis added.) That subsection, § 522(b), does not define the "property claimed as exempt" by reference to the estimated market value on which Reilly and the Court of Appeals rely. Section 522(b) refers only to property defined in § 522(d), which in turn lists 12 categories of property that a debtor may claim as exempt. As we have recognized, most of these categories (and all of the categories applicable to Reilly's exemptions) define the "property" a debtor may "clai[m] as exempt" as the debtor's "interest"—up to a specified dollar amount—in the assets described in the category, not as the assets themselves.

Viewing Reilly's form entries in light of this definition, we agree with Schwab and the United States that Schwab had no duty to object to the property Reilly claimed as exempt (two interests in her business equipment worth $1,850 and $8,868) because the stated value of each interest, and thus of the "property claimed as exempt," was within the limits the Code allows.

For all of these reasons, we conclude that Schwab was entitled to evaluate the propriety of the claimed exemptions based on three, and only three, entries on Reilly's Schedule C: the description of the business equipment in which Reilly claimed the exempt interests; the Code provisions governing the claimed exemptions; and the amounts Reilly listed in the column titled "value of claimed exemption." In reaching this conclusion, we do not render the market value estimate on Reilly's Schedule C superfluous. We simply confine the estimate to its proper role: aiding the trustee in administering the estate by helping him identify assets that may have value beyond the dollar amount the debtor claims as exempt, or whose full value may not be available for exemption because a portion of the interest is, for example, encumbered by an unavoidable lien.

The Court of Appeals erred in holding that our decision in *Taylor* dictates a contrary conclusion. The debtor in *Taylor*, like the debtor here, filed a schedule of exemptions with the Bankruptcy Court on which the debtor described the property subject to the claimed exemption, identified the Code provision supporting the exemption, and listed the dollar value of the exemption. Critically, however, the debtor in *Taylor* did not, like the debtor here, state the value of the claimed exemption as a specific dollar amount at or below the limits the Code allows. Instead, the debtor in Taylor listed the value of the exemption itself as "$ unknown":

The interested parties in *Taylor* agreed that this entry rendered the debtor's claimed exemption objectionable on its face because the exemption concerned an asset (lawsuit proceeds) that the Code did not permit the debtor to exempt beyond a specific dollar amount. Accordingly, although this case and *Taylor* both concern the consequences of a trustee's failure to object to a claimed exemption within the time specified by Rule 4003, the question arose in Taylor on starkly different facts. In *Taylor*, the question concerned a trustee's obligation to object to the debtor's entry of a "value claimed exempt" that was not plainly within the limits the Code allows. In this

case, the opposite is true. The amounts Reilly listed in the Schedule C column titled "Value of Claimed Exemption" are facially within the limits the Code prescribes and raise no warning flags that warranted an objection.

Taylor supports this conclusion. In holding otherwise, the Court of Appeals focused on what it described as *Taylor's* "`unstated premise'" that "`a debtor who exempts the entire reported value of an asset is claiming the "full amount," whatever it turns out to be.'" But *Taylor* does not rest on this premise. It establishes and applies the straightforward proposition that an interested party must object to a claimed exemption if the amount the debtor lists as the "value claimed exempt" is not within statutory limits, a test the value ($ unknown) in Taylor failed, and the values ($8,868 and $1,850) in this case pass.

We adhere to this test. We take Reilly's exemptions at face value and find them unobjectionable under the Code, so the objection deadline we enforced in Taylor is inapplicable here. Where, as here, it is important to the debtor to exempt the full market value of the asset or the asset itself, our decision will encourage the debtor to declare the value of her claimed exemption in a manner that makes the scope of the exemption clear, for example, by listing the exempt value as "full fair market value (FMV)" or "100% of FMV." Such a declaration will encourage the trustee to object promptly to the exemption if he wishes to challenge it and preserve for the estate any value in the asset beyond relevant statutory limits. If the trustee fails to object, or if the trustee objects and the objection is overruled, the debtor will be entitled to exclude the full value of the asset. If the trustee objects and the objection is sustained, the debtor will be required either to forfeit the portion of the exemption that exceeds the statutory allowance, or to revise other exemptions or arrangements with her creditors to permit the exemption. Either result will facilitate the expeditious and final disposition of assets, and thus enable the debtor (and the debtor's creditors) to achieve a fresh start free of the finality and clouded-title concerns Reilly describes.

Where, as here, a debtor accurately describes an asset subject to an exempt interest and on Schedule C declares the "value of [the] claimed exemption" as a dollar amount within the range the Code allows, interested parties are entitled to rely upon that value as evidence of the claim's validity. Accordingly, we hold that Schwab was not required to object to Reilly's claimed exemptions in her business equipment in order to preserve the estate's right to retain any value in the equipment beyond the value of the exempt interest. In reaching this conclusion, we express no judgment on the merits of, and do not foreclose the courts from entertaining on remand, procedural or other measures that may allow Reilly to avoid auction of her business equipment.

5.5. Exemption Planning

Suppose your client owns a $1 million home in California which has a $100,000 homestead exemption, and is about to file bankruptcy due to massive unpaid unsecured debts. Can you advise your client to sell the California home, use the money to buy a home in Florida or Texas (which have unlimited homestead exemptions), and exempt the property?

In the 2005 BAPCPA amendments, Congress limited this ploy, which had been used by many high profile debtors including former Commissioner of Baseball Bowie Kuhn and O.J. Simpson, by first requiring debtors to live in the new state for 730 days before using the new state's homestead exemptions, but also by directly targeting interstate homestead conversions. If a debtor

sells a homestead in one state and buys one in another state within a 10 year period prior to bankruptcy with the intention of hindering, delaying or defrauding creditors, the debtor's increased exemption is disallowed. 11 U.S.C. § 522(o). The disallowance in 522(o) is not limited to homestead to homestead conversions, but would also cover the conversion of other non-exempt property into a state law homestead. In 1985, Congress also added two confusingly worded provisions limiting homesteads to $146,450, applicable to debtors who convert non-exempt property into an exempt homestead within 1215 days before bankruptcy (unless by rollover in the same state), or committed certain crimes or torts. 11 U.S.C. § 522(p), (q). The limits are adjusted for inflation, and at the time of this writing are $155,675.

These specific limitations do not address the general question of exemption planning. Is it acceptable for a debtor to convert non-exempt to exempt property in planning for bankruptcy, as long as the debtor is careful not to trip one of the wires in Sections 522(o)-(q)? Read the following cases and ask yourself, where is the line between legal exemption planning and bankruptcy abuse?

5.6. Cases on Exemption Planning

5.6.1. NORWEST BANK NEBRASKA v. OMAR A. TVETEN, 848 F.2d 871 (8th Cir. 1988)

Appellant Omar A. Tveten, a physician who owed creditors almost $19,000,000, mostly in the form of personal guaranties on a number of investments whose value had deteriorated greatly, petitioned for Chapter 11 bankruptcy. He had converted almost all of his non-exempt property, with a value of about $700,000, into exempt property that could not be reached by his creditors. The bankruptcy court denied a discharge in view of its finding that Tveten intended to defraud, delay, and hinder his creditors. On appeal, Tveten asserts that his transfers merely constituted astute pre-bankruptcy planning. We hold that the bankruptcy court was not clearly erroneous in inferring fraudulent intent on the part of Tveten. We affirm.

We shall summarize only those facts and prior proceedings believed necessary to an understanding of the issues raised on appeal.

[Tveten invested in highly leveraged real estate developments with various physician friends.] The physicians, including Tveten, personally had guaranteed the debt arising out of these investments. In mid-1985, Tveten's investments began to sour. He became personally liable for an amount close to $19,000,000 — well beyond his ability to pay.

Before filing for bankruptcy, Tveten consulted counsel. As part of his pre-bankruptcy planning, he liquidated almost all of his non-exempt property, converting it into exempt property worth approximately $700,000. This was accomplished through some seventeen separate transfers. The non-exempt property he liquidated included land sold to his parents and his brother, respectively, for $70,000 and $75,732 in cash; life insurance policies and annuities with a for-profit company with cash values totaling $96,307.58; his net salary and bonuses of $27,820.91; his KEOGH plan and individual retirement fund of $20,487.35; his corporation's profit-sharing plan worth $325,774.51; and a home sold for $50,000. All of the liquidated property was converted into life insurance or annuity contracts with the Lutheran Brotherhood, a fraternal benefit

association, which, under Minnesota law, cannot be attached by creditors. Tveten concedes that the purpose of these transfers was to shield his assets from creditors. Minnesota law provides that creditors cannot attach any money or other benefits payable by a fraternal benefit association. Minn.Stat. §§ 550.37, 64B.18 (1986). Unlike most exemption provisions in other states, the Minnesota exemption has no monetary limit. Indeed, under this exemption, Tveten attempted to place $700,000 worth of his property out of his creditors' reach.

Tveten sought a discharge with respect to $18,920,000 of his debts. Appellees objected to Tveten's discharge. The bankruptcy court concluded that, although Tveten's conversion of non-exempt property to exempt property just before petitioning for bankruptcy, standing alone, would not justify denial of a discharge, his inferred intent to defraud would. The bankruptcy court held that, even if the exemptions were permissible, Tveten had abused the protections permitted a debtor under the Bankruptcy Code (the "Code"). Accordingly, the bankruptcy court denied Tveten a discharge.

The sole issue on appeal is whether Tveten properly was denied a discharge in view of the transfers alleged to have been in fraud of creditors.

At the outset, it is necessary to distinguish between (1) a debtor's right to exempt certain property from the claims of his creditors and (2) his right to a discharge of his debts. The Code permits a debtor to exempt property. . . . When the debtor claims a state-created exemption, the scope of the claim is determined by state law. It is well established that under the Code the conversion of non-exempt to exempt property for the purpose of placing the property out of the reach of creditors, without more, will not deprive the debtor of the exemption to which he otherwise would be entitled. Both the House and Senate Reports regarding the debtor's right to claim exemptions state:

"As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law."

H.R.Rep. No. 595, 95th Cong., 1st Sess. 361 (1977), reprinted in 1978 U.S.Code Cong. & Ad.News 5963, 6317; S.Rep. No. 989, 95th Cong., 2d Sess. 76 (1978), reprinted in 1978 U.S.Code Cong. & Ad.News 5787, 5862. The rationale behind this policy is that "[t]he result which would obtain if debtors were not allowed to convert property into allowable exempt property would be extremely harsh, especially in those jurisdictions where the exemption allowance is minimal." This blanket approval of conversion is qualified, however, by denial of discharge if there was extrinsic evidence of the debtor's intent to defraud creditors.

A debtor's right to a discharge, however, unlike his right to an exemption, is determined by federal, not state, law. The Code provides that a debtor may be denied a discharge under Chapter 7 if, among other things, he has transferred property "with intent to hinder, delay, or defraud a creditor" within one year before the date of the filing of the petition. Although Tveten filed for bankruptcy under Chapter 11, the proscription against discharging a debtor with fraudulent intent in a Chapter 7 proceeding is equally applicable against a debtor applying for a Chapter 11 discharge. The reason for this is that the Code provides that confirmation of a plan does not discharge a Chapter 11 debtor if "the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title." 11 U.S.C. § 1141(d)(3)(C) (1982).

As the bankruptcy court correctly found here, the issue in the instant case revolves around whether there was extrinsic evidence to demonstrate that Tveten transferred his property on the eve of bankruptcy with intent to defraud his creditors. The bankruptcy court's finding that there was such intent to defraud may be reversed by us only if clearly erroneous.

There are a number of cases in which the debtor converted non-exempt property to exempt property on the eve of bankruptcy and was granted a discharge because there was no extrinsic evidence of the debtor's intent to defraud. In *Forsberg [v. Security State Bank, 15 F.2d 499 (8th Cir.1926)]*, a debtor was granted a discharge despite his trade of non-exempt cattle for exempt hogs while insolvent and in contemplation of bankruptcy. Although we found that the trade was effected so that the debtor could increase his exemptions, the debtor "should [not] be penalized for merely doing what the law allows him to do." We concluded that "before the existence of such fraudulent purpose can be properly found, there must appear in evidence some facts or circumstances which are extrinsic to the mere facts of conversion of nonexempt assets into exempt and which are indicative of such fraudulent purpose."

There also are a number of cases, however, in which the courts have denied discharges after concluding that there was extrinsic evidence of the debtor's fraudulent intent. In *Ford [v. Postin]*, 773 F.2d 52 (4th Cir. 1985)], the debtor had executed a deed of correction transferring a tract of land to himself and his wife as tenants by the entirety. The debtor had testified that his parents originally had conveyed the land to the debtor alone, and that this was a mistake that he corrected by executing a deed of correction. Under relevant state law, the debtor's action removed the property from the reach of his creditors who were not also creditors of his wife. The Fourth Circuit, in upholding the denial of a discharge, found significant the fact that this "mistake" in the original transfer of the property was "corrected" the day after an unsecured creditor obtained judgment against the debtor. 773 F.2d at 55. The Fourth Circuit held that the bankruptcy court, in denying a discharge, was not clearly erroneous in finding the requisite intent to defraud, after "[h]aving heard ... [the debtor's] testimony at trial and having considered the circumstances surrounding the transfer".

In *In re Reed*, [700 F.2d 986, 990 (5th Cir.1983)], shortly after the debtor had arranged with his creditors to be free from the payment obligations until the following year, he rapidly had converted non-exempt assets to extinguish one home mortgage and to reduce another four months before bankruptcy, and had diverted receipts from his business into an account not divulged to his creditors. The Fifth Circuit concluded that the debtor's "whole pattern of conduct evinces that intent." The court went further and stated: "It would constitute a perversion of the purposes of the Bankruptcy Code to permit a debtor earning $180,000 a year to convert every one of his major nonexempt assets into sheltered property on the eve of bankruptcy with actual intent to defraud his creditors and then emerge washed clean of future obligation by carefully concocted immersion in bankruptcy waters."

In most, if not all, cases determining whether discharge was properly granted or denied to a debtor who practiced "pre-bankruptcy planning", the point of reference has been the state exemptions if the debtor was claiming under them. Although discharge was not denied if the debtor merely converted his non-exempt property into exempt property as permitted under state law, the exemptions involved in these cases comported with federal policy to give the debtor a "fresh start" — by limiting the monetary value of the exemptions. This policy has been explicit, or at least implicit, in these cases. In *Forsberg*, for example, we stated that it is not fraudulent for an

individual who knows he is insolvent to convert non-exempt property into exempt property, thereby placing the property out of the reach of creditors "because the statutes granting exemptions have made no such exceptions, and because the policy of such statutes is to favor the debtors, at the expense of the creditors, in the limited amounts allowed to them, by preventing the forced loss of the home and of the necessities of subsistence, and because such statutes are construed liberally in favor of the exemption." Similarly, in *Ellingson* [63 B.R. 271 (N.D.Iowa 1986)] in holding that the debtors' conversion of non-exempt cash and farm machinery did not provide grounds for denial of a discharge, the court relied on the social policies behind the exemptions. The court found that the debtors' improvement of their homestead was consistent with several of these policies, such as protecting the family unit from impoverishment, relieving society from the burden of supplying subsidized housing, and providing the debtors with a means to survive during the period following their bankruptcy filing when they might have little or no income.

In the instant case, however, the state exemption relied on by Tveten was unlimited, with the potential for unlimited abuse. Indeed, this case presents a situation in which the debtor liquidated almost his entire net worth of $700,000 and converted it to non-exempt property in seventeen transfers on the eve of bankruptcy while his creditors, to whom he owed close to $19,000,000, would be left to divide the little that remained in his estate. Borrowing the phrase used by another court, Tveten "did not want a mere fresh start, he wanted a head start." His attempt to shield property worth approximately $700,000 goes well beyond the purpose for which exemptions are permitted. Tveten's reliance on his attorney's advice does not protect him here, since that protection applies only to the extent that the reliance was reasonable.

The bankruptcy court, as affirmed by the district court, examined Tveten's entire pattern of conduct and found that he had demonstrated fraudulent intent. We agree. While state law governs the legitimacy of Tveten's exemptions, it is federal law that governs his discharge. Permitting Tveten, who earns over $60,000 annually, to convert all of his major non-exempt assets into sheltered property on the eve of bankruptcy with actual intent to defraud his creditors "would constitute a perversion of the purposes of the Bankruptcy Code". Tveten still is entitled to retain, free from creditors' claims, property rightfully exempt under relevant state law.

We distinguish our decision in *Hanson v. First National Bank*, 848 F.2d 866 (8th Cir.1988), decided today. Hanson involves a creditor's objection to two of the debtors' claimed exemptions under South Dakota law, a matter governed by state law. The complaint centered on the Hansons' sale, while insolvent, of non-exempt property to family members for fair market value and their use of the proceeds to prepay their preexisting mortgage and to purchase life insurance policies in the limited amounts permissible under relevant state law. The bankruptcy court found no extrinsic evidence of fraud.

To summarize:

We hold that the bankruptcy court was not clearly erroneous in inferring fraudulent intent on the part of the debtor, rather than astute pre-bankruptcy planning, with respect to his transfers on the eve of bankruptcy which were intended to defraud, delay and hinder his creditors.

ARNOLD, Circuit Judge, dissenting.

The Court reaches a result that appeals to one's general sense of righteousness. I believe, however, that it is contrary to clearly established law, and I therefore respectfully dissent.

Dr. Tveten has never made any bones about what he is doing, or trying to do, in this case. He deliberately set out to convert as much property as possible into a form exempt from attachment by creditors under Minnesota law. Such a design necessarily involves an attempt to delay or hinder creditors, in the ordinary, non-legal sense of those words, but, under long-standing principles embodied both in judicial decisions and in statute, such a purpose is not unlawful.

To be sure, if there is extrinsic evidence of fraud, or of a purpose to hinder or delay creditors, discharge may and should be denied, but "extrinsic," in this context, must mean something beyond the mere conversion of assets into exempt form for the purpose of putting them out of the reach of one's creditors. If Tveten had lied to his creditors, like the debtor in *McCormick v. Security State Bank*, 822 F.2d 806 (8th Cir.1987), or misled them in some way, like the debtor in *In re Reed*, 700 F.2d 986 (5th Cir.1983), or transferred property for less than fair value to a third party, like the debtor in *Ford v. Poston*, 773 F.2d 52 (4th Cir.1985), we would have a very different case. There is absolutely no evidence of that sort of misconduct in this record, and the Court's opinion filed today cites none.

One is tempted to speculate what the result would have been in this case if the amount of assets converted had been $7,000, instead of $700,000. Indeed, the large amount of money involved is the only difference I can see between this case and *Forsberg*. It is true that the Forsberg opinion referred to "the limited amounts allowed to" debtors by exemptions, but whether exemptions are limited in amount is a legislative question ordinarily to be decided by the people's elected representatives, in this case the Minnesota Legislature. Where courts punish debtors simply for claiming exemptions within statutory limits, troubling problems arise in separating judicial from legislative power.

If there ought to be a dollar limit, and I am inclined to think that there should be, and if practices such as those engaged in by the debtor here can become abusive, and I admit that they can, the problem is simply not one susceptible of a judicial solution according to manageable objective standards. A good statement of the kind of judicial reasoning that must underlie the result the Court reaches today appears in *In re Zouhar*, 10 B.R. 154 (Bankr.D.N.M.1981), where the amount of assets converted was $130,000. The Bankruptcy Court denied discharge, stating, among other things, that "`there is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered.'" Id. at 157. If I were a member of the Minnesota Legislature, I might well vote in favor of a bill to place an over-all dollar maximum on any exemption. But sitting as a judge, by what criteria do I determine when this pig becomes a hog? If $700,000 is too much, what about $70,000? Would it matter if the debtor were a farmer, as in Forsberg, rather than a physician? (I ask the question because the appellee creditor's brief mentions the debtor's profession, which ought to be legally irrelevant, several times.)

Debtors deserve more definite answers to these questions than the Court's opinion provides. In effect, the Court today leaves the distinction between permissible and impermissible claims of exemption to each bankruptcy judge's own sense of proportion. As a result, debtors will be unable to know in advance how far the federal courts will allow them to exercise their rights under state law.

Where state law creates an unlimited exemption, the result may be that wealthy debtors like Tveten enjoy a windfall that appears unconscionable, and contrary to the policy of the

bankruptcy law. I fully agree with Judge Kishel, however, that "[this] result ... cannot be laid at [the] Debtor's feet; it must be laid at the feet of the state legislature."

I submit that Tveten did nothing more fraudulent than seek to take advantage of a state law of which the federal courts disapprove.

5.6.2. Notes on *Tveten*

On the same day that the opinion in *Tveten* was issued, the court also issued an opinion in *Hanson v. First National Bank in Brookings*, 848 F.2d 866 (8th Cir. 1988), in which they allowed those farmer debtors a discharge even though they had, after consulting with an attorney, converted approximately $30,000 in non-exempt property to exempt property on the eve of bankruptcy. The non-exempt property was sold to family members, and the debtors bought exempt life insurance policies and paid down their mortgages to the maximum amounts allowed under the state's homestead exemption. The only apparent distinctions between the cases were: (1) the professions of the debtors (farmer v. medical doctor), (2) the amounts involved ($30,000 v. $700,000), (3) the types of exemptions utilized (limited v. unlimited dollar amount exemptions), and (4) the determination by the bankruptcy court that the debtor had crossed the line into "actual intent to hinder, delay or default creditors" under 11 U.S.C. § 727(a)(2). Does the outcome in exemption planning cases depend on the length of the chancellor's (or bankruptcy judge's) foot?

5.7. Avoiding Liens that Impair Exemptions

Chapter 8 will be devoted to the trustee's (and the debtor's) avoiding powers, under which the trustee is given the power to set aside certain transactions that occurred pre-petition because the transactions were likely made in anticipation of filing bankruptcy. One important avoiding power is to be considered now, however, because it relates to exemptions.

Section 522(f)(1) of the Bankruptcy Code allows the debtor to avoid two kinds of liens that were obtained by creditors before the bankruptcy petition was filed, if and to the extent that the liens impair the debtor's exemptions. The two kinds of liens are: (1) non-possessory non-purchase money liens on consumer goods, and (2) judicial liens. When a lien is avoided, the creditor returns to unsecured status, and the exempt property is freed from the creditor's security interest.

Consumer goods lien avoidance is rarely used because other federal laws broadly prohibit most creditors from taking non-possessory non-purchase money security interests in consumer goods. *See* FTC Credit Practices Rule, 16 CFR § 444.2(4); Federal Reserve Board Credit Practices Rule (Reg AA), 12 CFR § 227.13(d) (prohibiting finance companies, retailers, credit unions and banks from taking non-purchase money security interests in consumer goods). Therefore, it is the power to avoid judicial liens that is most important.

Under Section 522(f)(1), the debtor can avoid only judicial liens (not consensual liens) on both real and personal property if the liens impair the debtor's exemptions. Judicial liens are those obtained by an unsecured creditor after obtaining a judgment against the debtor. The debtor **cannot**

avoid **consensual liens** (except in the unusual case of non-possessory non-purchase money liens on consumer goods).

There is a statutory test for determining the extent to which a potentially avoidable lien impairs the debtor's exemption. The test starts by adding (i) all liens against the property (including the lien being avoided) plus (ii) the full amount of the debtor's exemption. It then deducts the fair market value of the property. The negative amount (the amount by which liens and exemption exceeds value) is the amount of the judicial liens that may be avoided. 11 U.S.C. § 522(f)(2). A positive number (value exceeds liens and exemptions) means that judicial liens cannot be avoided because there is sufficient value to pay the liens in full and still provide the debtor with a full exemption.

Lien avoidance under Section 522 does not occur automatically. The debtor must file a motion to avoid the judicial liens. *See* Bankruptcy Rule 4003(d). If the motion is opposed, the court must hold a hearing to determine whether and to what extent the lien can be avoided. *See* Bankruptcy Rule 9014. In general, courts require the debtor to establish the value of the property, the amount of all liens, and the amount of the exemption.

The trickiest part of avoiding judicial liens is properly serving notice of the motion. Notice must be served in the same manner as a complaint. Bankruptcy Rule 9014. Bankruptcy Rule 7004 allows complaints to be served by mail, but they must be addressed "to the attention of an officer, a managing or general agent, or an agent authorized by appointment or by law to receive service of process," and upon the creditor. Bankruptcy Rule 7004(b)(3). Courts are very strict about compliance with the service requirement. It is good practice to serve the creditor and attorney at the addresses listed in the judgment, and also serving the creditors' officer or designated agent for service of process. A corporate search is required to determine the identity of the officer or agent. It is also difficult to determine who to serve for state or municipal entities. It is necessary to determine the appropriate method for service designated by state law. Bankruptcy Rule 7004(b)(6). Finally, there is a special trap hidden at the end of the rule requiring an officer of an insured depository institution to be served by <u>certified</u> mail. Bankruptcy Rule 7004(h).

5.8. Practice Problems: Avoiding Liens that Impair Exemptions

Determine whether the debtor can avoid the following liens on the following property:

Problem 1. The debtor owns a house worth $300,000, subject to a first mortgage of $175,000, a second mortgage of $75,000, a senior judicial lien of $40,000, and a junior judicial lien of $30,000. The Debtor has a $100,000 homestead exemption. How much of which liens can be avoided?

Problem 2. Same facts as (1) except the property is worth $400,000.

Problem 3. Same facts as (2) except the senior judicial lien is $15,000, and the junior judicial lien is $10,000.

Problem 4. The debtor's house is worth $300,000, and is subject to a first mortgage of $250,000, a judicial lien in second position of $40,000, and a junior mortgage in third position of

$50,000. The debtor has a $100,000 homestead. *See Kolich v. Antioch Laurel Veterinary Hospital*, 328 F.3d 406 (8th Cir. 2003).

Problem 5. Ten years before bankruptcy, the debtor's son was in a car accident driving the debtor's car. The other party to the accident sued the debtor's son and the debtor in tort, and recovered a default judgment for $50,000. The judgment creditor followed the state procedure for obtaining a judicial lien on any property owned by the debtor in the county. No lien attached at the time, however, because the debtor did not own any property in the county. Three years before bankruptcy, the Debtor purchased a house in the county for $100,000, paying $25,000 cash and borrowing $75,000 from a bank secured by a first mortgage against the property. The debtor has fallen on hard times, has filed bankruptcy, and wants to avoid the $50,000 judicial lien. The property is currently worth $120,000, and the Debtor has a $100,000 homestead exemption. Can the lien be avoided? Before you answer the question, read the next case and consider how the Supreme Court's ruling might apply to this situation.

5.9. Cases on Avoiding Liens that Impair Exemptions

5.9.1. FARREY v. SANDERFOOT, 500 U.S. 291 (1991)

Petitioner Jeanne Farrey and respondent Gerald Sanderfoot were married on August 12, 1966. The couple eventually built a home on 27 acres of land in Hortonville, Wisconsin, where they raised their three children. On September 12, 1986, the Wisconsin court grant[ed] a judgment of divorce and property division.

The decision awarded each party one-half of their net $60,600.68 marital estate. The decree granted Sanderfoot sole title to all the real estate and the family house, which was subject to a mortgage and which was valued at $104,000, and most of the personal property. For her share, Farrey received the remaining items of personal property and the proceeds from a court-ordered auction of the furniture from the home. The judgment also allocated the couple's liabilities. Under this preliminary calculation of assets and debts, Sanderfoot stood to receive a net award of $59,508.79, while Farrey's award would otherwise have been $1,091.90. To ensure that the division of the estate was equal, the court ordered Sanderfoot to pay Farrey $29,208.44, half the difference in the value of their net assets. Sanderfoot was to pay this amount in two installments: half by January 10, 1987, and the remaining half by April 10, 1987. To secure this award, the decree provided that Farrey "shall have a lien against the real estate property of [Sanderfoot] for the total amount of money due her pursuant to this Order of the Court, i. e. $29,208.44, and the lien shall remain attached to the real estate property . . . until the total amount of money is paid in full."

Sanderfoot never made the required payments nor complied with any other order of the state court. Instead, on May 4, 1987, he voluntarily filed for Chapter 7 bankruptcy. Sanderfoot listed the marital home and real estate on the schedule of assets with his bankruptcy petition and listed it as exempt homestead property. Exercising his option to invoke the state rather than the federal homestead exemption, Sanderfoot claimed the property as exempt "to the amount of $40,000." He also filed a motion to avoid Farrey's lien under [section § 522(f)(1) of the Bankruptcy Code], claiming that Farrey possessed a judicial lien that impaired his homestead exemption.

Farrey objected to the motion, claiming that § 522(f)(1) could not divest her of her interest in the marital home.

Farrey does not challenge the Court of Appeals' determination that her lien was a judicial lien, and waived any challenge as to whether Sanderfoot was otherwise entitled to a homestead exemption under state law. The sole question presented in this case is whether § 522(f)(1) permits Sanderfoot to avoid the fixing of Farrey's lien on the property interest that he obtained in the divorce decree.

The key portion of § 522(f) states that "the debtor may avoid the fixing of a lien on an interest . . . in property." Sanderfoot, following several Courts of Appeals, suggests that this phrase means that a lien may be avoided so long as it is currently fixed on a debtor's interest. Farrey, following Judge Posner's lead [in the Court of Appeals decision below], reads the text as permitting the avoidance of a lien only where the lien attached to the debtor's interest at some point after the debtor obtained the interest.

We agree with Farrey. No one asserts that the two verbs underlying the provision possess anything other than their standard legal meaning: "avoid" meaning "annul" or "undo," and "fix" meaning to "fasten a liability upon." The statute does not say that the debtor may undo a lien on an interest in property. Rather, the statute expressly states that the debtor may avoid "the fixing" of a lien on the debtor's interest in property. The gerund "fixing" refers to a temporal event. That event—the fastening of a liability— presupposes an object onto which the liability can fasten. The statute defines this pre-existing object as "an interest of the debtor in property." Therefore, unless the debtor had the property interest to which the lien attached at some point before the lien attached to that interest, he or she cannot avoid the fixing of the lien under the terms of § 522(f)(1).

The text, history, and purpose of § 522(f)(1) also indicate what the provision is not concerned with. It cannot be concerned with liens that fixed on an interest before the debtor acquired that interest. Neither party contends otherwise. Section 522(f)(1) does not state that any fixing of a lien may be avoided; instead, it permits avoidance of the "fixing of a lien on an interest of the debtor." If the fixing took place before the debtor acquired that interest, the "fixing" by definition was not on the debtor's interest. Nor could the statute apply given its purpose of preventing a creditor from beating the debtor to the courthouse, since the debtor at no point possessed the interest without the judicial lien. There would be no fixing to avoid since the lien was already there. To permit lien avoidance in these circumstances, in fact, would be to allow judicial lienholders to be defrauded through the conveyance of an encumbered interest to a prospective debtor. For these reasons, it is settled that a debtor cannot use § 522(f)(1) to avoid a lien on an interest acquired after the lien attached. As before, the critical inquiry remains whether the debtor ever possessed the interest to which the lien fixed, before it fixed. If he or she did not, § 522(f)(1) does not permit the debtor to avoid the fixing of the lien on that interest.

Whether Sanderfoot ever possessed an interest to which the lien fixed, before it fixed, is a question of state law. Farrey contends that prior to the divorce judgment, she and her husband held title to the real estate in joint tenancy, each possessing an undivided one-half interest. She further asserts that the divorce decree extinguished these previous interests. At the same time and in the same transaction, she concludes, the decree created new interests in place of the old: for Sanderfoot, ownership in fee simple of the house and real estate; for Farrey, various assets and a

debt of $29,208.44 secured by a lien on the Sanderfoot's new fee simple interest. Both in his briefs and at oral argument, Sanderfoot agreed on each point.

On the assumption that the parties characterize Wisconsin law correctly, Sanderfoot must lose. Under their view, the lien could not have fixed on Sanderfoot's pre-existing undivided half interest because the divorce decree extinguished it. Instead, the only interest that the lien encumbers is debtor's wholly new fee simple interest. The same decree that awarded Sanderfoot his fee simple interest simultaneously granted the lien to Farrey. As the judgment stated, he acquired the property "free and clear" of any claim "except as expressly provided in this [decree]." Sanderfoot took the interest and the lien together, as if he had purchased an already encumbered estate from a third party. Since Sanderfoot never possessed his new fee simple interest before the lien "fixed," § 522(f)(1) is not available to void the lien.

The same result follows even if the divorce decree did not extinguish the couple's pre-existing interests but instead merely reordered them. The parties' current position notwithstanding, it may be that under Wisconsin law the divorce decree augmented Sanderfoot's previous interest by adding to it Farrey's prior interest. If the court in exchange sought to protect Farrey's previous interest with a lien, § 522(f)(1) could be used to undo the encumbrance to the extent the lien fastened to any portion of Sanderfoot's previous surviving interest. This follows because Sanderfoot would have possessed the interest to which that part of the lien fixed, before it fixed. But in this case, the divorce court did not purport to encumber any part of Sanderfoot's previous interest even on the assumption that state law would deem that interest to have survived. The decree instead transferred Farrey's previous interest to Sanderfoot and, again simultaneously, granted a lien equal to that interest minus the small amount of personal property she retained. Sanderfoot thus would still be unable to avoid the lien in this case since it fastened only to what had been Farrey's pre-existing interest, and this interest Sanderfoot would never have possessed without the lien already having fixed.

Farrey obtained the lien not to defeat Sanderfoot's pre-existing interest in the homestead but to protect her own pre-existing interest in the homestead that was fully equal to that of her spouse. The divorce court awarded the lien to secure an obligation the court imposed on the husband in exchange for the court's simultaneous award of the wife's homestead interest to the husband. We agree with Judge Posner that to permit a debtor in these circumstances to use the Code to deprive a spouse of this protection would neither follow the language of the statute nor serve the main goal it was designed to address.

We hold that § 522(f)(1) of the Bankruptcy Code requires a debtor to have possessed an interest to which a lien attached, before it attached, to avoid the fixing of the lien on that interest. Accordingly, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

5.9.2. OWEN v. OWEN, 500 U.S. 305 (1991)

JUSTICE SCALIA delivered the opinion of the Court.

The Bankruptcy Code allows the States to define what property a debtor may exempt from the bankruptcy estate that will be distributed among his creditors. 11 U. S. C. § 522(b). The Code

also provides that judicial liens encumbering exempt property can be eliminated. § 522(f). The question in this case is whether that elimination can operate when the State has defined the exempt property in such a way as specifically to exclude property encumbered by judicial liens.

In 1975, Helen Owen, the respondent, obtained a judgment against petitioner Dwight Owen, her former husband, for approximately $160,000. The judgment was recorded in Sarasota County, Florida, in July 1976. Petitioner did not at that time own any property in Sarasota County, but under Florida law, the judgment would attach to any after-acquired property recorded in the county. In 1984, petitioner purchased a condominium in Sarasota County; upon acquisition of title, the property became subject to respondent's judgment lien.

One year later, Florida amended its homestead law so that petitioner's condominium, which previously had not qualified as a homestead, thereafter did. Under the Florida Constitution, homestead property is "exempt from forced sale . . . and no judgment, decree or execution [can] be a lien thereon . . .," Fla. Const., Art. 10, § 4(a). The Florida courts have interpreted this provision, however, as being inapplicable to pre-existing liens, *i. e.*, liens that attached before the property acquired its homestead status. Pre-existing liens, then, are in effect an exception to the Florida homestead exemption.

In January 1986, petitioner filed for bankruptcy under Chapter 7 of the Code, and claimed a homestead exemption in his Sarasota condominium. The condominium, valued at approximately $135,000, was his primary asset; his liabilities included approximately $350,000 owed to respondent. The Bankruptcy Court discharged petitioner's personal liability for these debts, and sustained, over respondent's objections, his claimed exemption.

The condominium, however, remained subject to respondent's pre-existing lien, and after discharge, petitioner moved to reopen his case to avoid the lien pursuant to § 522(f)(1). The Bankruptcy Court refused to decree the avoidance; the District Court affirmed, finding that the lien had attached before the property qualified for the exemption, and that Florida law therefore did not exempt the lien-encumbered property. The Court of Appeals for the Eleventh Circuit affirmed on the same ground. We granted certiorari.

An estate in bankruptcy consists of all the interests in property, legal and equitable, possessed by the debtor at the time of filing, as well as those interests recovered or recoverable through transfer and lien avoidance provisions. An exemption is an interest withdrawn from the estate (and hence from the creditors) for the benefit of the debtor. Section 522 determines what property a debtor may exempt. Under § 522(b), he must select between a list of federal exemptions (set forth in § 522(d)) and the exemptions provided by his State, "unless the State law that is applicable to the debtor . . . specifically does not so authorize," §522(b)(1)— that is, unless the State "opts out" of the federal list. If a State opts out, then its debtors are limited to the exemptions provided by state law. Nothing in subsection (b) (or elsewhere in the Code) limits a State's power to restrict the scope of its exemptions; indeed, it could theoretically accord no exemptions at all.

Property that is properly exempted under § 522 is (with some exceptions) immunized against liability for prebankruptcy debts. § 522(c). No property can be exempted (and thereby immunized), however, unless it first falls *within* the bankruptcy estate. Section 522(b) provides that the debtor may exempt certain property "from property of the estate"; obviously, then, an interest that is not possessed by the estate cannot be exempted. Thus, if a debtor holds only bare legal title to his house—if, for example, the house is subject to a purchase-money mortgage for its

full value—then only that legal interest passes to the estate; the equitable interest remains with the mortgage holder, § 541(d). And since the equitable interest does not pass to the estate, neither can it pass to the debtor as an exempt interest in property. Legal title will pass, and can be the subject of an exemption; but the property will remain subject to the lien interest of the mortgage holder. This was the rule of *Long* v. *Bullard,* 117 U. S. 617 (1886), codified in § 522. Only where the Code empowers the court to avoid liens or transfers can an interest originally not within the estate be passed to the estate, and subsequently (through the claim of an exemption) to the debtor.

It is such an avoidance provision that is at issue here, to which we now turn. Section 522(f) reads as follows:

> "(f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—
>
> (1) a judicial lien; or
>
> (2) a nonpossessory, nonpurchase-money security interest . . . ."

The lien in the present case is a judicial lien, and we assume without deciding that it fixed "on an interest of the debtor in property." See *Farrey* v. *Sanderfoot*. The question presented by this case is whether it "impairs an exemption to which [petitioner] would have been entitled under subsection (b)." Since Florida has chosen to opt out of the listed federal exemptions, the only subsection (b) exemption at issue is the Florida homestead exemption described above. Respondent suggests that, to resolve this case, we need only ask whether the judicial lien impairs that exemption. It obviously does not, since the Florida homestead exemption is not assertable against pre-existing judicial liens. To permit avoidance of the lien, respondent urges, would not *preserve* the exemption but would *expand* it.

At first blush, this seems entirely reasonable. Several Courts of Appeals in addition to the Eleventh Circuit here have reached this result with respect to built-in limitations on state exemptions,[1] though others have rejected it. What must give us pause, however, is that this result has been widely *and uniformly* rejected with respect to built-in limitations on the *federal* exemptions. Most of the federally listed exemptions (set forth in § 522(d)) are explicitly restricted to the "debtor's aggregate interest" or the "debtor's interest" up to a maximum amount. See §§ 522(d)(1)-(6), (8). If respondent's approach to § 522(f) were applied, all of these exemptions (and perhaps others as well) would be limited by unavoided encumbering liens, see § 522(c). The federal homestead exemption, for example, allows the debtor to exempt from the property of the estate "[t]he debtor's aggregate interest, not to exceed $7,500 in value, in . . . a residence." § 522(d)(1). If respondent's interpretation of § 522(f) were applied to this exemption, a debtor who owned a house worth $10,000 that was subject to a judicial lien for $9,000 would not be entitled to the full homestead exemption of $7,500. The judicial lien would not be avoidable under § 522(f), since it does not "impair" the exemption, which is limited to the debtor's "aggregate interest" of $1,000. The uniform practice of bankruptcy courts, however, is to the contrary. To determine the application of § 522(f) they ask not whether the lien impairs an exemption to which the debtor is

in fact entitled, but whether it impairs an exemption to which he *would have been* entitled but for the lien itself.

As the preceding italicized words suggest, this reading is more consonant with the text of § 522(f)—which establishes as the baseline, against which impairment is to be measured, not an exemption to which the debtor "*is* entitled," but one to which he *"would have been* entitled." The latter phrase denotes a state of affairs that is conceived or hypothetical, rather than actual, and requires the reader to disregard some element of reality. "Would have been" *but for what?* The answer given, with respect to the federal exemptions, has been *but for the lien at issue,* and that seems to us correct.

The only other conceivable possibility is *but for a waiver*— harking back to the beginning phrase of § 522(f), "Notwithstanding any waiver of exemptions . . . ." The use of contrary-to-fact construction after a "notwithstanding" phrase is not, however, common usage, if even permissible. Moreover, though one might employ it when the "notwithstanding" phrase is the main point of the provision in question ("Notwithstanding any waiver, a debtor shall retain those exemptions to which he would have been entitled under subsection (b)"), it would be most strange to employ it where the "notwithstanding" phrase, as here, is an aside. The point of § 522(f) is not to exclude waivers (though that is done in passing, waivers are addressed directly in § 522(e)) but to provide that the debtor may avoid the fixing of a lien. In that context, for every instance in which "would have been entitled" may be accurate (because the incidentally mentioned waiver occurred) there will be thousands of instances in which "is entitled" should have been used. It seems to us that "would have been entitled" must refer to the generality, if not indeed the universality, of cases covered by the provision; and on that premise the only conceivable fact we are invited to disregard is the existence of the lien.

This reading must also be accepted, at least with respect to the federal exemptions, if § 522(f) is not to become an irrelevancy with respect to the most venerable, most common, and most important exemptions. The federal exemptions for homesteads (§ 522(d)(1)), for motor vehicles (§ 522(d)(2)), for household goods and wearing apparel (§ 522(d)(3)), and for tools of the trade (§ 522(d)(6)), are all defined by reference to the debtor's "interest" or "aggregate interest," so that if respondent's interpretation is accepted, no encumbrances of these could be avoided. Surely § 522(f) promises more than that—and surely it would be bizarre for the federal scheme to prevent the avoidance of liens on those items, but to permit it for the less crucial items (for example, an "unmatured life insurance contract owned by the debtor," § 522(d)(7)) that are not described in such fashion as unquestionably to exclude liens.

We have no doubt, then, that the lower courts' unanimously agreed-upon manner of applying § 522(f) to federal exemptions—ask first whether avoiding the lien would entitle the debtor to an exemption, and if it would, then avoid and recover the lien—is correct. The question then becomes whether a different interpretation should be adopted for state exemptions. We do not see how that could be possible. Nothing in the text of § 522(f) remotely justifies treating the two categories of exemptions differently. The provision refers to the impairment of "exemption[s] to which the debtor would have been entitled under subsection (b)," and that includes federal exemptions and state exemptions alike. Nor is there any overwhelmingly clear policy impelling us, if we possessed the power, to create a distinction that the words of the statute do not contain. Respondent asserts that it is inconsistent with the Bankruptcy Code's "opt-out" policy, whereby the States may define their own exemptions, to refuse to take those exemptions with all their built-

in limitations. That is plainly not true, however, since there is no doubt that a state exemption which purports to be available "unless waived" will be given full effect, *even if it has been waived*, for purposes of § 522(f)—the first phrase of which, as we have noted, recites that it applies "[n]otwithstanding any waiver of exemptions." Just as it is not inconsistent with the policy of permitting state-defined exemptions to have another policy disfavoring waiver of exemptions, whether federal- or state-created; so also it is not inconsistent to have a policy disfavoring the impingement of certain types of liens upon exemptions, whether federal- or state-created. We have no basis for pronouncing the opt-out policy absolute, but must apply it along with whatever other competing or limiting policies the statute contains.

On the basis of the analysis we have set forth above with respect to federal exemptions, and in light of the equivalency of treatment accorded to federal and state exemptions by § 522(f), we conclude that Florida's exclusion of certain liens from the scope of its homestead protection does not achieve a similar exclusion from the Bankruptcy Code's lien avoidance provision.

The foregoing conclusion does not necessarily resolve this case. Section 522(f) permits the avoidance of the "fixing of a lien on an interest of the debtor." Some courts have held it inapplicable to a lien that was already attached to property when the debtor acquired it, since in such a case there never was a "*fixing* of a lien" on *the debtor's* interest. Under Florida law, the lien may have attached simultaneously with the acquisition of the property interest. If so, it could be argued that the lien did not fix "on an interest of the debtor." See *Farrey* v. *Sanderfoot*. The Court of Appeals did not pass on this issue, nor on the subsidiary question whether the Florida statute extending the homestead exemption was a taking, We express no opinion on these points, and leave them to be considered by the Court of Appeals on remand.

Chapter 6. The Automatic Stay

6.1. What is the Automatic Stay?

The automatic stay, 11 U.S.C. § 362, protects the debtor and the estate from the harassment of collection actions during the bankruptcy case. The stay is very broad, prohibiting creditors from doing or continuing most kinds of collection activity against the debtor or the estate. 11 U.S.C. § 362(a).

Section 362(b) identifies certain acts that are not stayed, including criminal actions (11 U.S.C. § 362(b)(1)), certain family law proceedings (11 U.S.C. § 362(b)(2)), so-called "police and regulatory powers" (buried in 11 U.S.C. § 362(b)(4)), and eviction actions against residential tenants in certain situations (11 U.S.C. § 362(b)(22-23)).

The stay terminates automatically when the bankruptcy case is completed or the discharge is issued (11 U.S.C. § 362(c)), and there are important provisions for creditors to obtain relief from the automatic stay by motion (11 U.S.C. § 362(d)). We will cover relief from stay when we look at claims and distribution in Chapter 8.

Creditors who violate the automatic stay are in contempt of court and subject to severe penalties. *See* 11 U.S.C. § 362(k). The following problems explore the statutory language.

6.2. Practice Problems: The Automatic Stay

Read Section 362(a) and (b) and determine whether the following acts violate the automatic stay:

Problem 1. Continuing a deposition of the Debtor scheduled before the bankruptcy case was filed in a collection action against the Debtor.

Problem 2. The debtor was one of 100 defendants in an environmental lawsuit filed by a private landholder prior to bankruptcy. On the eve of trial the debtor filed bankruptcy. May the trial proceed? What can the plaintiff do to avoid a significant waste of time and money in its action against all of the other defendants? *See* 11 U.S.C. § 362(d)(1).

Problem 3. On the day of bankruptcy, the debtor was in default under a car loan to Syracuse Credit Union, and also had $1,000 in a checking account at Syracuse Credit Union. New York law gives banks and credit unions a right to setoff money owing to the credit union by a customer against money owing by the bank or credit union to the customer in the form of deposit accounts. May Syracuse Credit Union exercise the right of setoff after bankruptcy? 11 U.S.C. § 362(a)(7). What should be bank do if the debtor asks to withdraw the $1,000 from her checking account after bankruptcy? *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995) (allowing administrative freeze).

Problem 4. A Credit card company sent the debtor her regular monthly invoice of charges made during the prior month. Does it matter whether the credit card company received the bankruptcy notice before sending the invoice? *See* 11 U.S.C. § 362(k). Does it matter that on the

back of the invoice, in small print, is the following language: "if the debtor has filed bankruptcy, this is not an attempt to collect a debt but is merely a notice of the balance of the account."?

Problem 5. After filing bankruptcy, the debtor calls her credit union to ask whether they will continue to allow her to use her credit card. The credit union tells the debtor that they will restore her privileges only if she pays her credit card balance in full. Did the credit union violate the automatic stay? 11 U.S.C. § 362(a)(6).

Problem 6. Credit union sends the debtor a letter offering to restore her credit card privileges if she reaffirms her credit card. Is this a violation of the automatic stay?

> Note: as discussed below in Section 11.9, reaffirmation is a process by which the debtor requests that a debt not be discharged. *See* *Jamo v. Katahdin Federal Credit Union*, 283 F.3d 392 (1st Cir.2002) ("A creditor may discuss and negotiate terms for reaffirmation with a debtor without violating the automatic stay as long as the creditor refrains from coercion or harassment"); *Matter of Duke*, 79 F.3d 43 (7th Cir.1996) (Permissible to send non-threatening offer to provide small additional credit line if debtor will reaffirm dischargeable debt).

Problem 7. Prior to bankruptcy and after obtaining a default judgment against the debtor, creditor delivered a writ of garnishment to the sheriff directing the sheriff to garnish the debtor's wages. The Sheriff served the writ on the debtor's employer before bankruptcy was filed. Debtor demands that the creditor and Sheriff withdraw garnishment. Creditor refuses, saying he has no obligation to do anything since he has not taken a post-petition "act" in violation of the automatic stay. Who is right? *See* *In re Sucre*, 226 B.R. 340, 347 (Bankr.S.D.N.Y.1998) ("The provisions of the automatic stay place the responsibility to discontinue any pending collection proceedings squarely on the shoulders of the creditor who initiated the action."); *In re Sams*, 106 B.R. 485, 490 (Bankr. S.D. Ohio 1989) ("incumbent upon creditors to take necessary steps to halt or reverse pending state court actions or other collection efforts commenced prior to the filing of a bankruptcy petition"); *In Re Henry*, 328 B.R. 664 (Bankr. E.D.N.Y. 2005) (attorneys for creditor who failed to remove bank account garnishment liable for willfully violating automatic stay).

Problem 8. Debtor's college refuses to issue a diploma or transcript for the debtor because the debtor owes prepetition fees to the college. Is the refusal to issue a diploma or transcript a violation of the automatic stay? Does it matter that the fees are not dischargeable? *See* *Merchant v. Andrews University*, 958 F.2d 738 (6th Cir. 1992) (holding Andrews University liable for violating the automatic stay even though the debt was not dischargeable); *but see* *In re Watson*, 78 B.R. 232 (9th Cir. BAP 1987) (after obtaining non-dischargeability determination, creditor may attempt to collect debt from non-estate property).

Problem 9. Debtor filed a prepetition tort action against the driver of a car who rear-ended him at a stop light. The driver has refused to attend his deposition, claiming that the action is stayed by the Debtor's bankruptcy filing. Is the driver right? *See* 11 U.S.C. § 362(a)(1).

Problem 10. National Gridlock, the local gas and electric company, has informed the debtor that his utility services will be discontinued unless he gives the utility company a deposit equal to the highest two month's charges during the prior 12 months. Can they do that? *See* 11 U.S.C. § 366(a) and (b).

Problem 11. The debtor filed bankruptcy one hour before the Bank's scheduled foreclosure sale. The Bank held the foreclosure sale as scheduled and sold the property to a bidder who knew nothing of the bankruptcy. Did the Bank violate the automatic stay? Does it matter whether the Bank knew about the bankruptcy before the sale? In either case, what liability would the bank have? *See* 11 U.S.C. § 362(k). Must the Bank do anything after learning of the bankruptcy to avoid liability for punitive damages?

Problem 12. After receiving debtor's bankruptcy notice, creditor called debtor and threatened to file a criminal complaint with the district attorney unless the debtor's bad check was immediately paid. Is this a violation of the automatic stay? 11 U.S.C. § 362(a)(6). What if creditor, without making a threat, simply filed a criminal complaint after receiving the debtor's bankruptcy notice?

Problem 13. Debtor embezzled money from his employer, pled guilty, and agreed to pay $500 per month in criminal restitution to the employer as part of a plea bargain deal. Debtor is two payments behind and the state has filed an action to impose jail time for the debtor's failure to pay criminal restitution. Is the action stayed? *See* 11 U.S.C. § 362(b)(1); *Mead v. Director, Office of Adult Probation*, 41 B.R. 838 (Bankr. D. Conn. 1984).

Problem 14. Prior to filing bankruptcy, the debtor operated a silver mine, and used hazardous chemicals in its mining operation. The debtor no longer operates the mine. The State environmental protection agency commenced an action against the debtor prepetition seeking a mandatory injunction requiring the debtor to clean up the site. The sole purpose of the suit is to force the debtor to pay money for the cleanup. Is the action stayed? *See* 11 U.S.C. § 362(b)(4). If a money judgment is recovered after the debtor fails to comply with the cleanup order, can it be enforced against property of the estate? Is there a distinction under the statute between public safety and welfare on the one hand and the government's pecuniary interest on the other?

The meaning of the "police powers" exception has been fertile ground for litigation. The courts have broadly interpreted the exemption to allow the government to bring actions to obtain a money judgment. The problem is when the government crosses the line into enforcement of a money judgment. Does a mandatory injunction, ordering the debtor to clean up the site, cross the line? *See* *Penn Terra, Ltd. V. Department of Env. Resources*, 733 F.2d 267 (3d Cir. 1984) (no because environmental policy supersedes bankruptcy policy even if compliance with the injunction would require the payment of money); *Ohio v. Kovacs*, 469 U.S. 274 (1985) (yes where debtor no longer in control of property); *Board of Governers v. MCorp Financial, Inc.*, 502 U.S. 32 (1991) (bankruptcy court has no power to enjoin non-final administrative proceedings); *Berg v. Good Samaritan Hosp. Inc.*, 230 F.3d. 1165 (9th Cir. 2000) (award of attorney fees against a debtor for engaging in frivolous litigation not stayed)

Problem 15. After filing bankruptcy, debtor borrowed $500 from a friend, promising to pay it back within 10 days. Debtor failed to pay the money back, and stopped returning the friend's calls. May the friend sue the Debtor to recover the $500 plus interest without violating the automatic stay? 11 U.S.C. § 362(a)(1).

Problem 16. After receiving notice of the debtor's bankruptcy, the debtor's credit union called the debtor to demand payment of the debtor's car loan balance. Debtor's attorney filed an action against the credit union for violating the automatic stay. Credit union sought to avoid liability for attorney's fees by offering to pay any actual damages incurred by the debtor. Debtor

demanded payment of legal fees and penalties, and threatened to recover more legal fees prosecuting the case if the amounts demanded were not paid. Can the Debtor recover legal fees incurred to recover damages, or only legal fees incurred to prevent a continuing violation of the automatic stay? *Compare* *Sternberg v. Johnson*, 595 F.3d 937 (9th Cir. 2010) ("actual damages, including costs and attorneys' fees" meant to apply only to attorneys' fees incurred to prevent actual damages); *In re Repine*, 536 F.3d 512 (5th Cir. 2008) (successful plaintiff can recover attorneys' fees incurred in recovering damages and penalties). Can credit union defend a request for sanctions on the grounds that it did not "intend" to violate the stay because it was unaware of the law? *See e.g.* *In re AP Industries, Inc.*, 117 B.R. 789, 803 (Bankr. S.D.N.Y 1990) (willful violation if debtor acts deliberately with knowledge of the bankruptcy petition).

Problem 17. Debtor filed a Chapter 13 case 4 years ago, was unable to complete her payments, and her case was dismissed nine months ago. The debtor would like to file a new case under Chapter 7. Is there anything the debtor will need to do with respect to the automatic stay? *See* 11 U.S.C. § 362(c)(3).

6.3. Cases on Using the Automatic Stay as a Sword

6.3.1. SPORTFRAME OF OHIO v. WILSON SPORTING GOODS, 40 B.R. 47 (Bankr. N.D. Ohio 1984)

Plaintiff's complaint [seeks] an injunction to require defendant to sell inventory to it on a cash basis, [plus an award of] attorney's fees and costs for an alleged violation of the automatic stay of 11 U.S.C. § 362(a).

Plaintiff Sportfame runs four retail sporting goods stores in Ohio. Defendant, Wilson has sold its line of sporting goods to plaintiff at wholesale for almost 10 years until recently when it refused to ship any further goods to plaintiff.

On February 14, 1983 plaintiff filed a voluntary petition under Chapter 11 of the Bankruptcy Code. Sometime prior to the filing of the petition, plaintiff became in arrears with defendant for shipments of goods in the amount of approximately $18,000. Due to the arrearage, defendant ceased shipping goods to plaintiff prior to the filing of the petition.

In March and April of 1983 Sam R. Shible, president of Sportfame, contacted defendant's credit manager by telephone in an attempt to have shipments of inventory resumed. Mr. Shible attempted to buy goods from defendant for cash. Defendant, while aware of the Chapter 11 proceeding, refused to resume shipments of goods unless plaintiff brought its account current or made arrangements to pay 100% of the arrearage.

As a result of defendant's refusal to fill plaintiff's orders, plaintiff can no longer supply its customers with the Wilson line of sporting goods. Plaintiff asserts that defendant's refusal to resume shipments of goods absent full payment of its debt contravenes 11 U.S.C. § 362(a)(6) which stays "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case. . . ." Plaintiff seeks an injunction that would require defendant to resume supplying it with inventory on a cash basis and attorney's fees and costs for the present action.

Plaintiff first contends that defendant's refusal to ship goods to it is in violation of § 362(a)(6) of the Code which provides that a petition in bankruptcy operates as a stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title. . . ." Defendant denies this contention, instead asserting that it cut off shipment of goods prior to the filing of the petition in this case and that, instead of asking for repayment of its debt, it only sought to encourage debtor to submit a plan calling for 100% repayment of its debts. Upon the evidence adduced at trial in this case, the Court concludes that defendant's actions contravene § 362 of the Code.

Defendant's sole animus in refusing to ship goods to debtor for cash was its desire to coerce debtor's repayment of its prepetition indebtedness and that this act, albeit a passive one, was an "act to collect, assess, or recover a claim against the debtor" in contravention of 11 U.S.C. § 362(a)(6). As one commentator has remarked, "[t]he stay of section 362 is extremely broad in scope and . . . should apply to almost any type of formal or informal action against the debtor or property of the estate." 2 *Collier on Bankruptcy*, ¶ 362.04 at 362-27 (15th ed. 1979). Section 362(a)(6), in particular, was intended to prevent any kind of attempt to collect prepetition debts: In the present case, although it was the debtor and not the creditor who initiated the contact and despite the fact that this is not a consumer bankruptcy, under the circumstances of this case, Wilson's act was inherently coercive and against the spirit of the bankruptcy laws.

While perhaps unremarkable otherwise, Wilson's actions take on an added significance upon the filing of a petition in bankruptcy. Wilson could have simply refused, for any reason, to sell goods to debtor or offered no explanation for its refusal to do business. Instead, its sole reason for refusing to sell goods to debtor was its desire to collect its prepetition debt. The act in this context had the effect of interfering with the reorganization effort, a result at odds with the purpose of the bankruptcy laws.

As plaintiff points out, an analogy can be drawn from those cases that have found that a state university's refusal to issue a transcript to a debtor absent payment of prepetition debt, in addition to constituting a type of discriminatory treatment by a governmental unit proscribed by 11 U.S.C. § 525, when motivated by the sole purpose of attempting to collect a prepetition debt, violated § 362(a)(6). *In re Parkman*, 27 B.R. 460 (Bkrtcy. N.D. Ill. 1983). In addition, the Court in *Parkman* enjoined the university from barring the debtor from classes during the pendency of the Chapter 13 proceeding.

More directly on point is *In re Haffner*, 25 B.R. 882, 9 BCD 1293 (Bkrtcy. N.D. Ind. 1982). In *Haffner* [farmer debtors who] sought to store grain with the Commodity Credit Corporation (CCC) were told the transaction could be made only if CCC retained, or setoff from the amount that otherwise would be paid to the debtors, amounts which were due or allegedly due from a prepetition transaction of a similar nature in accordance with federal regulations. The Court found that the regulations, to the extent that they require the retention of money to recover prepetition debts in a postpetition transaction, violated the automatic stay of § 362(a)(6). The court went on in *Haffner* to order the CCC to enter into the transaction with debtor and to pay over the usual amount to debtor without any setoff.

It seems clear from the foregoing discussion that ample authority exists for the finding that Wilson violated the automatic stay by refusing to enter into cash transactions with debtor absent payment of its prepetition debt where its sole motivation was to collect its prepetition debt. While

clear, in retrospect, that the stay was violated, due to the relatively obscure nature of the violation in this case, the Court is inclined to deny debtor's prayer for costs and attorney's fees in this case. Debtor's prayer for an injunction requiring Wilson to fill postpetition orders for goods, however, should be granted.

There remains the question of the terms and duration of the order. The debtor shall be required to pay cash either in advance of or upon receipt of goods. Upon receipt of debtor's order, Wilson should ship goods without undue delay and shall not unreasonably discriminate against debtor's orders. As far as possible, the parties shall operate on a normal business relationship consistent with their previous course of dealing over the past ten years. Although debtor has requested an order of unlimited duration, the spirit of this order, to remedy the violation of stay and promote the rehabilitation effort, can only justify its continuance through the course of this reorganization proceeding.

6.3.2. CITY OF CHICAGO v. FULTON, 141 S.Ct. 585 (2021)

When a debtor files a petition for bankruptcy, the Bankruptcy Code protects the debtor's interests by imposing an automatic stay on efforts to collect prepetition debts outside the bankruptcy forum. Those prohibited efforts include "any act ... to exercise control over property" of the bankruptcy estate. 11 U.S.C. § 362(a)(3). The question in this case is whether an entity violates that prohibition by retaining possession of a debtor's property after a bankruptcy petition is filed. We hold that mere retention of property does not violate § 362(a)(3).

Under the Bankruptcy Code, the filing of a bankruptcy petition has certain immediate consequences. For one thing, a petition "creates an estate" that, with some exceptions, comprises "all legal or equitable interests of the debtor in property as of the commencement of the case." Section 541 "is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code." One such provision, § 542, is important for present purposes. Titled "Turnover of property to the estate," § 542 provides, with just a few exceptions, that an entity (other than a custodian) in possession of property of the bankruptcy estate "shall deliver to the trustee, and account for" that property.

A second automatic consequence of the filing of a bankruptcy petition is that, with certain exceptions, the petition "operates as a stay, applicable to all entities," of efforts to collect from the debtor outside of the bankruptcy forum. § 362(a). The automatic stay serves the debtor's interests by protecting the estate from dismemberment, and it also benefits creditors as a group by preventing individual creditors from pursuing their own interests to the detriment of the others. Under the Code, an individual injured by any willful violation of the stay "shall recover actual damages, including costs and attorneys' fees, and in appropriate circumstances, may recover punitive damages." § 362(k)(1).

Among the many collection efforts prohibited by the stay is "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." § 362(a)(3). The prohibition against exercising control over estate property is the subject of the present dispute.

In the case before us, the city of Chicago (City) impounded each respondent's vehicle for failure to pay fines for motor vehicle infractions. Each respondent filed a Chapter 13 bankruptcy petition and requested that the City return his or her vehicle. The City refused, and in each case a bankruptcy court held that the City's refusal violated the automatic stay. The Court of Appeals affirmed all of the judgments in a consolidated opinion. The court concluded that "by retaining possession of the debtors' vehicles after they declared bankruptcy," the City had acted "to exercise control over" respondents' property in violation of § 362(a)(3). We granted certiorari to resolve a split in the Courts of Appeals over whether an entity that retains possession of the property of a bankruptcy estate violates § 362(a)(3). We now vacate the judgment below.

The language used in § 362(a)(3) suggests that merely retaining possession of estate property does not violate the automatic stay. Under that provision, the filing of a bankruptcy petition operates as a "stay" of "any act" to "exercise control" over the property of the estate. Taken together, the most natural reading of these terms—"stay," "act," and "exercise control" —is that § 362(a)(3) prohibits affirmative acts that would disturb the status quo of estate property as of the time when the bankruptcy petition was filed.

Taking the provision's operative words in turn, the term "stay" is commonly used to describe an order that "suspend[s] judicial alteration of the status quo." An "act" is "[s]omething done or performed ...; a deed." To "exercise" in the sense relevant here means "to bring into play" or "make effective in action." And to "exercise" something like control is "to put in practice or carry out in action." The suggestion conveyed by the combination of these terms is that § 362(a)(3) halts any affirmative act that would alter the status quo as of the time of the filing of a bankruptcy petition.

We do not maintain that these terms definitively rule out the alternative interpretation adopted by the court below and advocated by respondents. As respondents point out, omissions can qualify as "acts" in certain contexts, and the term "`control'" can mean "`to have power over.'" But saying that a person engages in an "act" to "exercise" his or her power over a thing communicates more than merely "having" that power. Thus the language of § 362(a)(3) implies that something more than merely retaining power is required to violate the disputed provision.

Any ambiguity in the text of § 362(a)(3) is resolved decidedly in the City's favor by the existence of a separate provision, § 542, that expressly governs the turnover of estate property. Section 542(a), with two exceptions, provides as follows:

> "[A]n entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."

The exceptions to § 542(a) shield (1) transfers of estate property made from one entity to another in good faith without notice or knowledge of the bankruptcy petition and (2) good-faith transfers to satisfy certain life insurance obligations. Reading § 362(a)(3) to cover mere retention of property, as respondents advocate, would create at least two serious problems.

First, it would render the central command of § 542 largely superfluous. Reading "any act ... to exercise control" in § 362(a)(3) to include merely retaining possession of a debtor's property

would make that section a blanket turnover provision. But as noted, § 542 expressly governs "[t]urnover of property to the estate," and subsection (a) describes the broad range of property that an entity "shall deliver to the trustee." That mandate would be surplusage if § 362(a)(3) already required an entity affirmatively to relinquish control of the debtor's property at the moment a bankruptcy petition is filed.

Respondents and their amici contend that § 542(a) would still perform some work by specifying the party to whom the property in question must be turned over and by requiring that an entity "account for ... the value of" the debtor's property if the property is damaged or lost. But that is a small amount of work for a large amount of text in a section that appears to be the Code provision that is designed to govern the turnover of estate property. Under this alternative interpretation, § 362(a)(3), not § 542, would be the chief provision governing turnover —even though § 362(a)(3) says nothing expressly on that question. And § 542 would be reduced to a footnote—even though it appears on its face to be the governing provision. The better account of the two provisions is that § 362(a)(3) prohibits collection efforts outside the bankruptcy proceeding that would change the status quo, while § 542(a) works within the bankruptcy process to draw far-flung estate property back into the hands of the debtor or trustee.

Second, respondents' reading would render the commands of § 362(a)(3) and § 542 contradictory. Section 542 carves out exceptions to the turnover command, and § 542(a) by its terms does not mandate turnover of property that is "of inconsequential value or benefit to the estate." Under respondents' reading, in cases where those exceptions to turnover under § 542 would apply, § 362(a)(3) would command turnover all the same. But it would be "an odd construction" of § 362(a)(3) to require a creditor to do immediately what § 542 specifically excuses. Respondents would have us resolve the conflicting commands by engrafting § 542's exceptions onto § 362(a)(3), but there is no textual basis for doing so.

The history of the Bankruptcy Code confirms what its text and structure convey. Both § 362(a)(3) and § 542(a) were included in the original Bankruptcy Code in 1978. At the time, § 362(a)(3) applied the stay only to "any act to obtain possession of property of the estate or of property from the estate." The phrase "or to exercise control over property of the estate" was not added until 1984.

Respondents do not seriously dispute that § 362(a)(3) imposed no turnover obligation prior to the 1984 amendment. But transforming the stay in § 362 into an affirmative turnover obligation would have constituted an important change. And it would have been odd for Congress to accomplish that change by simply adding the phrase "exercise control," a phrase that does not naturally comprehend the mere retention of property and that does not admit of the exceptions set out in § 542. Had Congress wanted to make § 362(a)(3) an enforcement arm of sorts for § 542(a), the least one would expect would be a cross-reference to the latter provision, but Congress did not include such a cross-reference or provide any other indication that it was transforming § 362(a)(3). The better account of the statutory history is that the 1984 amendment, by adding the phrase regarding the exercise of control, simply extended the stay to acts that would change the status quo with respect to intangible property and acts that would change the status quo with respect to tangible property without "obtain[ing]" such property.

Though the parties debate the issue at some length, we need not decide how the turnover obligation in § 542 operates. Nor do we settle the meaning of other subsections of § 362(a).[2] We

hold only that mere retention of estate property after the filing of a bankruptcy petition does not violate § 362(a)(3) of the Bankruptcy Code. The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

Sotomayor J, concurring

Although the Court today holds that § 362(a)(3) does not require creditors to turn over impounded vehicles, bankruptcy courts are not powerless to facilitate the return of debtors' vehicles to their owners. Most obviously, the Court leaves open the possibility of relief under § 542(a). That section requires any "entity," subject to some exceptions, to turn over "property" belonging to the bankruptcy estate. 11 U.S.C. § 542(a). The debtor, in turn, must be able to provide the creditor with "adequate protection" of its interest in the returned property, § 363(e); for example, the debtor may need to demonstrate that her car is sufficiently insured. In this way, § 542(a) maximizes value for all parties involved in a bankruptcy: The debtor is able to use her asset, which makes it easier to earn an income; the debtor's unsecured creditors, in turn, receive timely payments from the debtor; and the debtor's secured creditor, for its part, receives "adequate protection [to] replace the protection afforded by possession." Secured creditors cannot opt out of this arrangement. As even the City acknowledges, § 542(a) "impose[s] a duty of turnover that is mandatory when the statute's conditions ... are met."

The trouble with § 542(a), however, is that turnover proceedings can be quite slow. The Federal Rules of Bankruptcy Procedure treat most "proceeding[s] to recover... property" as "adversary proceedings." Rule 7001(1). Such actions are, in simplified terms, "essentially full civil lawsuits carried out under the umbrella of [a] bankruptcy case." Because adversary proceedings require more process, they take more time. Of the turnover proceedings filed after July 2019 and concluding before June 2020, the average case was pending for over 100 days.

One hundred days is a long time to wait for a creditor to return your car, especially when you need that car to get to work so you can earn an income and make your bankruptcy-plan payments. To address this problem, some courts have adopted strategies to hurry things along. At least one bankruptcy court has held that § 542(a)'s turnover obligation is automatic even absent a court order. Other courts apparently will permit debtors to seek turnover by simple motion, in lieu of filing a full adversary proceeding, at least where the creditor has received adequate notice. Similarly, even when a turnover request does take the form of an adversary proceeding, bankruptcy courts may find it prudent to expedite proceedings or order preliminary relief requiring temporary turnover.

Ultimately, however, any gap left by the Court's ruling today is best addressed by rule drafters and policymakers, not bankruptcy judges. It is up to the Advisory Committee on Rules of Bankruptcy Procedure to consider amendments to the Rules that ensure prompt resolution of debtors' requests for turnover under § 542(a), especially where debtors' vehicles are concerned. Congress, too, could offer a statutory fix, either by ensuring that expedited review is available for § 542(a) proceedings seeking turnover of a vehicle or by enacting entirely new statutory mechanisms that require creditors to return cars to debtors in a timely manner.

Nothing in today's opinion forecloses these alternative solutions. With that understanding, I concur.

6.4. Extending The Stay to Non-Debtors

6.4.1. AH ROBINS CO, INC. v. PICCININ, 788 F. 2d 994 (4th Cir. 1986)

Confronted, if not overwhelmed, with an avalanche of actions filed in various state and federal courts throughout the United States by citizens of this country as well as of foreign countries seeking damages for injuries allegedly sustained by the use of an intrauterine contraceptive device known as a Dalkon Shield, the manufacturer of the device, A.H. Robins Company, Incorporated (Robins) filed its petition under Chapter 11 of the Bankruptcy Code.

In mid-1970 Robins acquired all patent and marketing rights to the Dalkon Shield and engaged in the manufacture and marketing of the device from early 1971 until 1974, when it discontinued manufacture and sale of the device because of complaints and suits charging injuries arising allegedly out of the use of the device. The institution of Dalkon Shield suits did not, however, moderate with the discontinuance of manufacture of the device, since Robins did not actually recall the device until 1984. By the middle of 1985, when the Chapter 11 petition was filed the number of such suits arising out of the continued sale and use of the Dalkon Shield device earlier put into the stream of commerce by Robins had grown to 5,000. More than half of these pending cases named Robins as the sole defendant; a co-defendant or co-defendants were named in the others. Prior to the filing, a number of suits had been tried and, while Robins had prevailed in some of the actions, judgments in large and burdensome amounts had been recovered in others. Many more had been settled. Moreover, the costs of defending these suits both to Robins and to its insurance carrier had risen into the millions. A large amount of the time and energies of Robins' officers and executives was also being absorbed in preparing material for trial and in attending and testifying at depositions and trials. The problems arising out of this mounting tide of claims and suits precipitated this Chapter 11 proceeding.

The filing of the Chapter 11 petition automatically stayed all suits against Robins itself under section 362(a) of the Bankruptcy Code, even though no formal order of stay was immediately entered. But a number of plaintiffs in suits where there were defendants other than Robins, sought to sever their actions against Robins and to proceed with their claims against the co-defendant or co-defendants. Robins responded to the move by filing an adversary proceeding in which it named as defendants the plaintiffs in eight such suits pending in various state and federal courts. In that proceeding, the debtor sought (1) declaratory relief adjudging that the debtor's products liability policy with Aetna Casualty and Insurance Company (Aetna) was an asset of the estate in which all the Dalkon Shield plaintiffs and claimants had an interest and (2) injunctive relief restraining the prosecution of the actions against its co-defendants.

The debtor's application for a temporary restraining order and for the setting of a date for a hearing on the request for preliminary injunction in the adversary proceeding was heard ex parte by the district judge who had jurisdiction over the proceedings. The district judge granted at the time a temporary restraining order in the proceedings and set a hearing on the debtor's application for a preliminary injunction.

At the hearing on the motion for a preliminary injunction, a number of defendants as well as the Committee constituted by the court to represent Dalkon Shield Claimants appeared by

counsel. At the commencement of the hearing the defendant Piccinin, a plaintiff in one of the Dalkon Shield actions which Robins sought to stay, filed through her attorney a written motion to dismiss as against her. No other defendant filed a motion in response to the motion for a preliminary injunction. After receiving certain testimony, admitting various records, and hearing arguments of parties, the district court granted Robins' request for a preliminary injunction.

In his order granting the preliminary injunction, the district judge found (1) that continuation of litigation in the civil actions threatened property of Robins' estate, burdened and impeded Robins' reorganization effort, contravened the public interest, and rendered any plan of reorganization futile; (2) that this burden on Robins' estate outweighed any burden on the Dalkon claimants caused by enjoining their civil actions; and (3) that all remaining insurance coverage in favor of the debtor under its liability policy issued by Aetna was property of the Robins' Chapter 11 estate. The district judge then held that all actions for damages that might be satisfied from proceeds of the Aetna insurance policy were subject to the stay.

Only the defendants Piccinin, the Mosas, and Conrad filed timely notices of appeal from the grant of the preliminary injunction. Their appeals, questioning the propriety of that preliminary injunction as against suits by Robins' co-defendants is the first of the issues now before this Court.

Some three weeks after entry of the preliminary injunction, Robins filed a motion for (1) a determination of trial venue of all Dalkon Shield suits, (2) identification of such Dalkon Shield cases as were "related to" the Chapter 11 case, and (3) transfer of such cases to the Eastern District of Virginia for trial. It also requested an expedited hearing on these motions. This request for an expedited hearing was granted and the expedited hearing was set ten days later.

After a hearing on the motions, the district judge entered an order holding that (1) pursuant to 28 U.S.C. § 1334(b), all actions based upon personal injury tort or wrongful death claims arising from the use of the Dalkon Shield were proceedings related to this Chapter 11 case over which this court had jurisdiction; (2) pursuant to 28 U.S.C. §§ 157(b)(5)[7] and 1334(b), all such actions, wherever pending, were to be tried in the Richmond Division of the United States District Court for the Eastern District of Virginia; (3) all actions related to the Robins' Chapter 11 case now pending in any federal district court or subsequently removed to any federal district court, during the pendency of this Chapter 11 case, were to be transferred to this court [the Richmond Division of the United States District Court]; and (4) nothing in the order limited the power of this court [the Richmond Division of the United States District Court] later to abstain from hearing any proceeding under section 1334(c)(1) or remanding under section 1452(b), 28 U.S.C.

The initial question in the appeal of the first issue relates to the court's jurisdiction to grant a stay or injunction of suits in other courts against co-defendants of the debtor or of third parties; none of the parties herein contest the jurisdiction of the bankruptcy court to stay actions against the debtor itself in any court. Jurisdiction over suits involving co-defendants or third-parties may be bottomed on two statutory provisions of the Bankruptcy Act itself as well as on the general equitable powers of the court. The first of these statutory grants of jurisdiction is found in section 362. The purpose of this section by its various subsections is to protect the debtor from an uncontrollable scramble for its assets in a number of uncoordinated proceedings in different courts, to preclude one creditor from pursuing a remedy to the disadvantage of other creditors, and to provide the debtor and its executives with a reasonable respite from protracted litigation, during which they may have an opportunity to formulate a plan of reorganization for the debtor. [As one

Court put it], "[t]he stay insures that the debtor's affairs will be centralized, initially, in a single forum in order to prevent conflicting judgments from different courts and in order to harmonize all of the creditors' interests with one another."

Section 362 is broken down into several subsections, only two of which are relevant on this appeal. The first of such subsections is (a)(1), which imposes an automatic stay of any proceeding "commenced or [that] could have been commenced against the debtor" at the time of the filing of the Chapter 11 proceeding; the second is (a)(3), which provides similar relief against suits involving the possession or custody of property of the debtor, irrespective of whether the suits are against the debtor alone or others. We shall discuss the extent of jurisdiction given the bankruptcy court under these two subsections, beginning with (a)(1).

Subsection (a)(1) is generally said to be available only to the debtor, not third party defendants or co-defendants. However, as the Court in Johns-Manville Sales Corp., 26 B.R. 405, 410 (S.D.N.Y .1983) remarked, "there are cases [under 362(a)(1)] where a bankruptcy court may properly stay the proceedings against non-bankrupt co-defendants" but, it adds, that in order for relief for such non-bankrupt defendants to be available under (a)(1), there must be "unusual circumstances" and certainly "`[s]omething more than the mere fact that one of the parties to the lawsuit has filed a Chapter 11 bankruptcy must be shown in order that proceedings be stayed against non-bankrupt parties.'" This "unusual situation," it would seem, arises when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor. An illustration of such a situation would be a suit against a third-party who is entitled to absolute indemnity by the debtor on account of any judgment that might result against them in the case. To refuse application of the statutory stay in that case would defeat the very purpose and intent of the statute. . . . [I]t is unimportant whether the stay is granted under section 362(a)(1) or on equitable grounds: the result is the same; a stay is proper in such a situation.

But (a)(1), which stays actions against the debtor and arguably against those whose interests are so intimately intertwined with those of the debtor that the latter may be said to be the real party in interest, is not the only part of section 362 providing for an automatic stay of proceedings. Subsection (a)(3) directs stays of any action, whether against the debtor or third-parties, to obtain possession or to exercise control over property of the debtor. A key phrase in the construction and application of this section is, of course, "property" as that term is used in the Act. Section 541(a)(1) of the Bankruptcy Act defines "property" in the bankruptcy context. It provides that the "estate is comprised of all the following property, wherever located ... all legal or equitable interests of the debtor in property as of the commencement of the case." The Supreme Court in construing this language in United States v. Whiting Pools, Inc., 462 U.S. 198, 205, [made it clear that the] scope of this paragraph [541(a)(1)] is broad. It included all kinds of property including tangible or intangible property, causes of action and all other forms of property currently specified in section 70a of the Bankruptcy Act."

Under the weight of authority, insurance contracts have been said to be embraced in this statutory definition of "property." For example, even the right to cancel an insurance policy issued to the debtor has uniformly been held to be stayed under section 362(a)(3). A products liability policy of the debtor is similarly within the principle: it is a valuable property of a debtor, particularly if the debtor is confronted with substantial liability claims within the coverage of the policy in which case the policy may well be, as one court has remarked in a case like the one under

review, "the most important asset of [i.e., the debtor's] estate." Any action in which the judgment may diminish this "important asset" is unquestionably subject to a stay under this subsection. Accordingly actions "related to" the bankruptcy proceedings against the insurer or against officers or employees of the debtor who may be entitled to indemnification under such policy or who qualify as additional insureds under the policy are to be stayed under section 362(a)(3).

The statutory power of the bankruptcy court to stay actions involving the debtor or its property is not, however, limited to section 362(a)(1) and (a)(3). It has been repeatedly held that 11 U.S.C. § 105 which provides that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," "empowers the bankruptcy court to enjoin parties other than the bankrupt" from commencing or continuing litigation.

Section 105 gives the court “the power to issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title.”

[T]he exceptions to the automatic stay of § 362(a) which are set forth in § 362(b) are simply exceptions to the stay which protect the estate automatically at the commencement of the case and are not limitations upon the jurisdiction of the bankruptcy court or upon its power to enjoin. That power is generally based upon § 105 of the Code. The court will have ample power to enjoin actions excepted from the automatic stay which might interfere in the rehabilitative process whether in a liquidation or in a reorganization case.

Accepting that section 105 confers on the bankruptcy court power . . . to enjoin suits against parties in other courts, whether state or federal, it is necessary to mark out the circumstances under which the power or jurisdiction may be exercised. In Otero Mills, the Court approved a ruling that "[t]o so enjoin a creditor's action against a third party, the court must find that failure to enjoin would effect [sic] the bankruptcy estate and would adversely or detrimentally influence and pressure the debtor through the third party." In Johns-Manville, the Court phrased somewhat fuller the circumstances when section 105 may support a stay:

In the exercise of its authority under § 105, the Bankruptcy Court may use its injunctive authority to "protect the integrity of a bankrupt's estate and the Bankruptcy Court's custody thereof and to preserve to that Court the ability to exercise the authority delegated to it by Congress" Pursuant to the exercise of that authority the Court may issue or extend stays to enjoin a variety of proceedings [including discovery against the debtor or its officers and employees] which will have an adverse impact on the Debtor's ability to formulate a Chapter 11 plan.

Beyond these statutory powers under section 362 and section 105 to enjoin other actions whether against the debtor or third-parties and in whatsoever court, the bankruptcy court under its comprehensive jurisdiction as conferred by 28 U.S.C. section 1334 has the "inherent power of courts under their general equity powers and in the efficient management of the dockets to grant relief" to grant a stay. In exercising such power the court, however, must "weigh competing interests and maintain an even balance" and must justify the stay "by clear and convincing circumstances outweighing potential harm to the party against whom it is operative."

There are thus four grounds on which the bankruptcy court may enjoin suits against the bankrupt or its assets and property. In some instances only one of these grounds may be relevant; in an involved and complex case, several or even all of the grounds may require consideration.

In the three situations in which the defendants have challenged the injunction granted by the district judge [i.e., the Mosa, Conrad and Piccinin cases], the only defendants other than the debtor, are the two Robins, Dr. Frederick A. Clark, Jr., Dr. Hugh J. Davis, and the debtor's insurer Aetna. So far as the suits against the two Robins and Dr. Clark, those defendants were entitled to indemnification by the debtor under the corporate by-laws and the statutes of Virginia, the State of debtor's incorporation, and were, in addition, additional insureds under the debtor's insurance policy. Dr. Davis was the beneficiary of an express contract of indemnification on the part of Robins and was, under a compromise agreement with Robins and Aetna, an additional insured under Robins' insurance policy. The Manville court had granted a preliminary injunction in favor of defendants in the same position as these defendants, as we have seen, on facts similar to those here, finding that the requirements of possible irreparable harm "had been satisfied by the showing ... [that the suits against the defendants would represent] an immediate and irreparable impact on the pool of insurance assets, of the existence of sufficiently serious questions going to the merits," and of the tipping in the defendants' favor in the hardships in a balancing of the debtor's and the plaintiffs'. That court had previously disposed of the public interest being weighted in the debtor's favor: "Indeed, this Court finds the goal of removing all obstacles to plan formulation eminently praiseworthy and supports every lawful effort to foster this goal while protecting the due process rights of all constituencies."

The district court in this case applied the test for a grant of preliminary injunctive relief. It found that irreparable harm would be suffered by the debtor and by the defendants since any of these suits against these co-defendants, if successful, would reduce and diminish the insurance fund or pool represented in Aetna's policy in favor of Robins and thereby affect the property of the debtor to the detriment of the debtor's creditors as a whole. The likelihood of success by the debtor under these circumstances appeared indisputable. The hardships which would be suffered irreparably by the debtor and by its creditors generally in permitting these plaintiffs to secure as it were a preference in the distribution of the insurance pool herein to which all creditors were entitled, together with the unquestioned public interest in promoting a viable reorganization of the debtor can be said to outweigh any contrary hardship to the plaintiffs.

The district court entered a ruling bringing for the time being all the pending suits against the debtor before the district court sitting in bankruptcy in order to proceed expeditiously in the reorganization but with the definite condition that any party might object and might petition for abstention in his or her case. It was in our opinion intended as a conditional order, though not clearly stated as such. We are of the opinion, because of this possible want of clarity in the order assailed, that such order must be modified to make it crystal clear that the determination of venue therein is, as we have said, conditional, dependent finally and ultimately on a ruling to be made only after notice to all claimants advising them of their right to enter any objections they may have to such a tentative ruling and to submit a motion for abstention in their particular case.

We do not presume to suggest rigid guidelines for the district judge to follow when considering objections to the transfer. We believe it important, however, to observe that although there may be distinct advantages of the tort claims being transferred to Richmond, those advantages should be balanced against the disadvantages that may be advanced at the hearing. In that regard, some cases may be fully prepared and ready for state trial. Some cases may require substantial numbers of local witnesses. Claimants may be receiving critical medical, physical or psychological care in a local area which would have to be halted or transferred to Richmond. All of these factors are

relevant. Moreover, there are issues of state law that may substantially affect the results in individual cases.

6.4.2. Note on IN RE QUIGLEY CO, 676 F.3d 45 (2d Cir. 2012)

Quigley was a wholly owned subsidiary of Pfizer that manufactured an asbestos product. The Bankruptcy Code contains a special provision adopted after the *Manville* case which allows as part of a plan for asbestos claims to be "channeled" to an alternative dispute resolution forum for determination and payment. 11 U.S.C. § 524(g). Quigley's bankruptcy plan provided for the channeling of all claims for which Quigley was liable to a particular forum for determination. Attorney Peter G Angelos brought a number of claims against Pfizer, claiming that it became liable for the asbestos injuries incurred by Quigley customers because Pfizer had allowed Quigley to put Pfizer's name on the product packaging. The issue was whether the channeling injunction in Quigley's bankruptcy, which followed the statutory language of Section 524(g), required Angelos's clients to bring their claims against Pfizer under the Quigley channeling procedures. The Court of Appeals held that the statutory channeling language incorporated by Quigley into its plan of reorganization did not apply to the claims against Pfizer which were not based on its ownership of Quigley, but were instead based on Quigley's permitted use of Pfizer's name on its packaging.

Chapter 7. Operating the Estate

7.1. The United States Trustee

The Office of the United States Trustee is part of the executive branch of the federal government supervised by the Attorney General of the United States. A United States Trustee is appointed by the Attorney General for each judicial district, and the people who work in the United States Trustee's office are civil servants. The job of the United States Trustee is to supervise the bankruptcy system; not to administer individual bankruptcy cases (which is the job of the similarly titled "trustee."). The United States Trustee reviews bankruptcy petitions for compliance with the rules (and carefully scrutinizes compliance with the means test), reviews fee applications, plans and disclosure statements, refers cases for criminal prosecution to the United States Attorney, supervises the appointment and election of trustees, maintains statistics on bankruptcy cases, and generally appears in bankruptcy cases to protect the integrity of the bankruptcy system from abuse. The specific duties of the United States Trustee are set forth in 28 U.S.C. § 586. Although the United States Trustee has the power to act as a case trustee by administering cases, the exercise of that power would be extremely unusual. Because of the United States Trustee's independence and expertise, a competent bankruptcy attorney must endeavor to address any concerns raised by the Office of the United States Trustee in a prompt and courteous manner, because an objection by the United States Trustee is generally given significant weight by the courts.

7.2. The Case Trustee

The case trustee's primary job is to maximize the value of the bankruptcy estate for unsecured creditors in a liquidation. The trustee must question the debtor to make sure the filed schedules are accurate and reflect all of the debtor's property. As will be discussed in Chapter 8, the trustee is also given avoiding powers to set aside prepetition transactions that are presumed to have been made in contemplation of bankruptcy and have harmed other unsecured creditors.

A trustee is appointed automatically in every Chapter 7 case. The United States Trustee maintains a panel of private attorneys or other professionals who have qualified to serve as trustees in bankruptcy cases. The cases are generally assigned randomly to a trustee on the panel to act as the "interim trustee." *See* 11 U.S.C. § 701.

The Bankruptcy Code contains an elaborate procedure for the election of a permanent trustee who is different from the interim trustee if creditors holding 20% of undisputed liquidated unsecured claims timely request an election. *See* 11 U.S.C. § 702. Such elections are very unusual in Chapter 7 cases. Elections generally happen only in large cases where sophisticated organized creditor groups seek the appointment of professionals experienced in a particular industry. In most ordinary cases, the interim panel trustee will automatically serve as the permanent trustee in the case because no election is requested.

Trustees must be independent and disinterested, bonded, and have no conflicts of interest with the debtor or the creditors. *See* 11 U.S.C. §§ 321, 322, 701. The trustee is a fiduciary of the estate, holds legal title to property of the estate in trust, and has the capacity to sue and be sued in

his or her official trustee capacity. A trustee receives a flat fee (currently $60) from the debtor's filing fees for acting as a trustee in the case. In addition, the trustee is entitled to reasonable compensation for services rendered in the case limited to a percentage of the money or property distributed to creditors. 11 U.S.C. § 326(a). Payment must come from the estate as an administrative claim. Trustees routinely seek to be paid the maximum percentage allowed based on the amount of money distributed, but the statute by its terms only allows compensation for the value of services rendered, limited by the maximum percentage fee. For significant compensation requests, judges should require the trustee to show the fees earned on a case, based on the hours worked on the case multiplied by an appropriate hourly rate. Trustees are expected to maintain time records just like other professionals.

The Trustee will review the debtor's petition and schedules, review the debtor's tax returns, and often will request additional documentation from the debtor to review (commonly 90 days of bank statements, copies of insurance policies, title documents for real estate, and pay stubs). A good lawyer will endeavor to provide the trustee with whatever documentation the trustee requests to avoid additional scrutiny and trustee objections.

7.3. The Section 341 Meeting

The first major event in most Chapter 7 bankruptcy cases is the Section 341 meeting (after 11 U.S.C. § 341), also known **in**appropriately as the first meeting of creditors. The meeting is badly named because, in most cases, creditors do not bother to come to the first meeting of creditors. At the meeting, the debtor is sworn in, provides identification documents to the trustee (driver's license and social security card), and is questioned by the trustee about the schedules. The proceeding is tape recorded. No judge is present during the meeting. Creditors may attend the meeting and ask a few questions, but will be told by the trustee to schedule an examination if the creditor starts to take up too much time. The election of a trustee is supposed to occur at the 341 meeting, but elections are only rarely requested. In typical consumer cases, there are 20-50 341 hearings scheduled back to back, and the hearings take about 10-15 minutes, with the following procedure:

(1) Debtor sworn in.
(2) Debtor provides driver's license and social security card to the trustee. Trustee verifies the numbers.
(3) Trustee gives tax returns back to the debtor and asks whether the returns correctly reflect what was filed with the tax authorities.
(4) Debtor is shown signature page from petition and is asked to verify signature. Debtor is asked if he or she read and reviewed the petition before signing it, and if it is true and complete, or if the debtor is aware of any inaccuracies or changes.
(5) Debtor is asked general questions about other possible assets: does the debtor have any claims for personal injury or property damage against anyone; did the debtor own any real property in the past several years (and if so, what happened to the property); what is the debtor's employment status; does the debtor expect any tax refunds; what

is the status of the debtor's secured loans; does the debtor have liability insurance to protect the public from the debtor's continued operation of a vehicle?

(6) Debtor is asked about valuable property listed in schedules, such as vehicles and collections.

(7) If information in the Debtor's schedules raises suspicions, the trustee will inquire further.

It is important to remember that most trustees have handled many cases, and can often tell when debtors are not telling the truth or are trying to hide something. It is important for debtor lawyers to ask thorough questions when preparing the petition and schedules to avoid the embarrassment caused at the 341 hearing when information not reflected in the schedules comes to light.

7.4. No Asset Cases

In many cases, the trustee will determine at the 341 hearing that all of the debtor's assets that have any value are exempt, and will file a "no asset" report. The "no asset" report indicates that the trustee has determined that nothing will be available to distribute to creditors. Following the trustee's "no asset" report, the debtor simply waits for the time period for parties in interest to object to the debtor's discharge to run, and then the discharge will be issued automatically by the bankruptcy court. Shortly thereafter, the case will be closed and the bankruptcy concluded. Most consumer debtors will complete their bankruptcy cases without ever appearing before a judge, and after having had to endure only brief gentle questioning by the trustee at the Section 341 meeting. The primary job of the debtor's lawyer in consumer Chapter 7 cases is to properly complete the petition and schedules.

7.5. Use, Sale and Lease of Property

The trustee has broad powers to use, sell and lease property of the estate in the ordinary course of business. 11 U.S.C. § 363(c)(1). The statutory starting place for this power is Section 363(c)(1), which gives the trustee the power to use, sell or lease property of the estate **in the ordinary course** of business **without** a court order, unless the court requires otherwise (or unless the court has prohibited the trustee from continuing to operate the debtor's business). Business as usual continues after bankruptcy under the trustee's supervision.

But the trustee's power to use, sell or lease property of the estate is limited by three automatic statutory restrictions.

First, under Section 365(b)(1), the trustee must obtain court approval, on notice to creditors and an opportunity for hearing, to use, sell or lease property of the estate **outside of the ordinary course** of business. When is the trustee's use, sale or lease of property **within** the "ordinary course" of business, and when is it **outside** the "ordinary course" of business (requiring court authorization)? Unfortunately, there is no clear line here. If it is the type of transaction that the debtor conducted on a regular basis in connection with the operation of its business before bankruptcy, then it will generally be within the ordinary course. For example, for a grocery store

debtor, the sale of food to ordinary customers at regular prices would be in the ordinary course of business, but the sale of all of the store's inventory to a single buyer (or the sale of store's real property) would not be in the ordinary course of business. The line between what is ordinary and what is not can easily become blurred, however. A cautious lawyer will advise a client to obtain approval when in doubt.

Second, the trustee cannot use **"cash collateral"** without either (1) the consent of the secured creditor or (2) court approval on notice to the secured creditor. 11 U.S.C. § 363(c)(2). Cash collateral is money (or money like property) that is subject to a creditor's security interest. 11 U.S.C. § 363(a)(1). Most commonly, cash received as proceeds from the sale of a secured creditor's collateral will be "cash collateral." On the other hand, the Trustee is allowed to use "free cash" that is not subject to a creditor's security interest in the ordinary course of business without court approval. It may be difficult for someone dealing with a trustee at arm's length to know the source of cash payments, so special care and attention are required when doing business with a trustee for cash.

Third, upon the request of a **secured creditor** at any time, the court must restrict the use, sale or lease of property of the estate if the creditor is not "**adequately protected**." 11 U.S.C. 363(e). The Bankruptcy Code does not explicitly define when secured creditors are entitled to "adequate protection," and thus the courts have been required to define the doctrine. One thing is clear about adequate protection – creditors may be entitled to receive adequate protection only if they ask the bankruptcy court for protection. Creditors who sleep on their rights cannot retroactively seek adequate protection. The fundamental concept of adequate protection – what it means, when creditors are entitled to it, and how it can be provided, will be discussed later in Section 9.14. For now, simply recognize that secured creditors who are at risk of losing some or all of the value of their collateral during the bankruptcy case by the trustee's use, sale or lease of their collateral are entitled to court protection if they request it.

These restrictions on the trustee's power to use, sell or lease property are important not only for the trustee but also for anyone dealing with the trustee, because the failure to obtain court approval for a transaction requiring court approval results in a transaction that can later be undone. 11 U.S.C. § 549(a). Thus, anyone dealing with the trustee must assure that the transaction is authorized before proceeding, or risk the later revocation of the transaction and the consequences that follow from revocation. The risk of avoidance is well illustrated by the *Marathon Oil* case, reprinted below.

7.6. Practice Problems: Sale of Property

Problem 1. Debtor and her former husband owned a house together for 20 years before their separation and divorce. As part of the divorce decree, each spouse retained a 50% interest in the house as tenants in common, with the husband remaining in possession of the house subject to an obligation to pay all accruing interest on the mortgage. Upon sale, each spouse was to get 50% of the remaining proceeds after satisfying the mortgage. The house was worth $100,000 more than the amount owing on the mortgage. The trustee would only be able to obtain about $10,000 for the Debtor's interest in the house, because anyone buying the house for its full value would want to live in it - not be a half owner with an ex-husband who is in possession of the house. Can the

Trustee sell the entire house and throw the husband out? If so, how would the proceeds from sale be divided between the trustee and the husband? If it costs a 6% sales commission, and the trustee's fees are $8,000, how much would the husband and the bankruptcy estate get? *See* 11 U.S.C. §§ 363(g)-(j).

Problem 2. Bank of Armenia holds a $200,000 mortgage against the house in the last problem, and has an ongoing lucrative business relationship with the Debtor's husband. At the husband's request, the Bank will not consent to a sale of the property. Can the house be sold free of Bank of Armenia's $200,000 mortgage without its consent? 11 U.S.C. § 363(f).

Problem 3. Bank of Armenia's mortgage contains the following clause: "If either mortgagor files a petition under Title 11 of the United States Code at any time, this mortgage will be fully due and payable immediately, and if the full balance of the loan is not paid within 10 calendar days, the mortgaged property will be deemed owned by Bank of Armenia free and clear of any interest in the mortgagors." Assume that this provision is valid under applicable state law, and that 10 days have passed since the bankruptcy filing without the loan being paid. Is the property no longer property of the estate that can be sold by the trustee? *See* 11 U.S.C. §§ 363(l); 541(C)(1).

Problem 4. Suppose the bankruptcy court in Problem (1) decides to authorize the sale of the house over the husband's objection. The husband appeals. While the appeal is pending, the trustee sells the property for fair value to the highest bidder at a public sale. The bidder knew about the appeal, but did not think the husband would win. After the buyer evicted the husband and lived in the house for more than a year, the appellate court finally issued a decision reversing the bankruptcy court's approval of the sale by finding that the detriment to the husband from the sale exceeded the benefit to the estate. Does the bidder have to give the house back to the husband? *See* 11 U.S.C. § 363(m). What could the losing party have done to prevent this result?

Problem 5. Debtor is a corporation that owns a hotel in a small tourist town. Your client is a bank that holds a mortgage on the hotel to secure a loan with a balance of $1.2 million. The hotel property is worth about $1.5 million. The Debtor is behind on the mortgage payments and has been having trouble making ends meet during the recent recession, but there seems to be a pickup in business as the economy recovers. Under the terms of the mortgage, the bank has a security interest in the rents generated by the hotel. The Debtor has filed a petition under Chapter 11 of the Bankruptcy Code, under which the Debtor, as a "debtor-in-possession," has the powers and duties of a trustee in the case. *See* 11 U.S.C. § 1107(a). The Debtor needs to use the rents from the hotel to pay the continuing expenses of operations, and asks your client to promptly consent to the Debtor's use of cash collateral so that payroll can be met the day after tomorrow, needed supplies can be purchased, and the Debtor can continue to pay the expenses of the business going forward while the Debtor puts together a plan of reorganization. What do you say in response to the Debtor's request for consent? What can the Debtor do if you simply say "no"?

7.7. Cases on the Sale of Property

7.7.1. MARATHON PETROLEUM v. COHEN, 599 F.3d 1255 (11th Cir. 2010)

Delco Oil, Inc. (Debtor) is a distributor of motor fuel and associated products. Debtor began purchasing petroleum products from Marathon in 2003 pursuant to a sales agreement. Debtor also entered into a financing agreement with CapitalSource Finance in April 2006, in which CapitalSource agreed to provide financing to Debtor in exchange for Debtor's pledge of all rights to Debtor's personal property, including collections, cash payments, and inventory.

On October 17, 2006, Debtor filed for Chapter 11 bankruptcy protection and filed an emergency motion with the bankruptcy court requesting authorization to use cash collateral to continue its operations. CapitalSource objected. On November 6, 2006 the bankruptcy court denied Debtor's request to use its cash collateral (later reduced to a written order). Between October 18 and November 6, however, Debtor distributed over $1.9 million in cash to Marathon in exchange for petroleum products pursuant to its sales agreement.

In December 2006, Debtor voluntarily converted its bankruptcy to a Chapter 7 proceeding and the bankruptcy court appointed Cohen as trustee. Cohen filed an adversary proceeding against Marathon to avoid the post-petition cash transfers and ultimately filed the motion for summary judgment that is the subject of this appeal. The bankruptcy court granted summary judgment in favor of Cohen and entered a judgment for $1,960,088.91 against Marathon, concluding Debtor used CapitalSource's cash collateral to pay Marathon without authorization.

The Bankruptcy Code prohibits the post-petition use of cash collateral by a trustee or a debtor-in-possession, unless the secured party or the bankruptcy court after notice and a hearing authorizes the use of cash collateral upon a finding that the secured party's interest in the cash is adequately protected. See 11 U.S.C. § 1107; 11 U.S.C. § 363(c)(2); 11 U.S.C. § 363(e). Section 363(c)(2) balances competing interests in a Chapter 11 reorganization. [A] debtor reorganizing his business has a compelling need to use cash collateral in order to meet its daily operating expenses and rehabilitate its business. At the same time, however, unhindered use of cash collateral, i.e., "secured `property' may result in the dissipation of the estate." Section 363(c)(2) resolves this tension between a debtor and a secured creditor by only allowing the debtor to use cash collateral after it has procured either the secured creditor's or the bankruptcy court's permission upon a showing that the secured creditor's interest is adequately protected.

Section 549(a) of the Bankruptcy Code authorizes a trustee to recover unauthorized post-petition transfers of estate property. To avoid a transfer under Section 549(a) a trustee need only demonstrate: (1) a post-petition transfer (2) of estate property (3) which was not authorized by the Bankruptcy Code or the court. After the trustee makes that showing, the party asserting an established transfer's validity bears the burden of proving it valid. Fed. R. Bankr.P. 6001. Once a court finds a transfer avoidable, Section 550(a) allows the trustee to recover the property transferred from the initial transferee.

Marathon asserts [that] the funds it received from Debtor [did not constitute] CapitalSource's cash collateral under [a Florida statute] which provides that "[a] transferee of funds

from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party."

Despite Marathon's contentions otherwise, [the Florida statute] does not alter the fact that CapitalSource had a security interest in Debtor's deposit account funds as proceeds of CapitalSource's properly secured collateral while they were in Debtor's hands. Therefore, those cash proceeds constituted cash collateral as defined by 11 U.S.C. § 363(a), and pursuant to 11 U.S.C. § 363(c)(2), Debtor could not transfer them to anyone without the authorization of CapitalSource or the bankruptcy court. Marathon correctly notes that under [the Florida statute] after Debtor transferred the funds to it, the funds in its hands were no longer subject to CapitalSource's security interest. Such a result, however, has no bearing on the following dispositive facts: (1) The bankruptcy code prohibited the transfer to Marathon altogether, because CapitalSource had a perfected security interest in Debtor's cash proceeds while they were in Debtor's hands, and (2) the bankruptcy code allows the trustee to avoid and take back unauthorized transfers. Marathon does not cite a single case from any circuit to dispute this conclusion, nor are we aware of any.

Lest any confusion exist, Cohen may avoid and recover from Marathon the funds Debtor transferred to it not because CapitalSource continued to have a security interest in the funds once they were in the hands of Marathon, but because Debtor was not authorized to transfer the funds to anyone post-petition without the permission of CapitalSource or the bankruptcy court. Otherwise, a debtor could circumvent Section 363(c)(2)'s prohibition on the use of cash collateral without the secured creditor's or bankruptcy court's permission by distributing cash proceeds it knows are subject to a security interest as it likes, knowing that once distributed the proceeds would not be defined as cash collateral under Section 363(a) and, therefore, the transfer would not violate Section 363(c). Such an outcome would render Section 363(c) virtually meaningless, leaving a debtor generally free to transfer cash or its equivalent that is subject to a security interest. Cohen, therefore, retains the power to avoid and recover these funds because before Debtor transferred them they constituted the proceeds of CapitalSource's perfected security interest in all of Debtor's personal property and, therefore, they constituted cash collateral which Section 363 prohibited Debtor from transferring to anyone without CapitalSource's or the court's permission.

Marathon also argues that the deposit account funds that Debtor transferred to it did not constitute cash collateral because CapitalSource did not perfect an interest in Debtor's deposit account by filing a deposit control agreement. But this argument is equally unpersuasive. No one disputes CapitalSource had a perfected security interest in all of Debtor's personal property. Thus, if the cash transferred constituted the proceeds of CapitalSource's collateral, CapitalSource need not have had a deposit account control agreement to perfect its security interest in the cash transferred.

Marathon, however, maintains a genuine issue of fact exists as to whether the funds it received from Debtor's accounts were identifiable proceeds of CapitalSource's secured collateral. In support of its motion for summary judgment, Cohen submitted the affidavit of Todd Gehrs, an officer of CapitalSource. In his affidavit, Gehrs stated that CapitalSource had duly perfected, first-priority security interests in all of Debtor's personal property, including all of Debtor's cash, accounts receivable, inventory, all cash collections, all rights to payment, and all proceeds thereof as of the bankruptcy petition date. Gehrs further stated all cash and all bank deposits maintained by Debtor as of the bankruptcy petition date constituted CapitalSource's cash collateral.

Additionally, he noted that the bankruptcy court in the underlying bankruptcy proceeding had already concluded that "CapitalSource [had] established that the post-petition funds in Debtor's bank accounts, constitute direct proceeds of its pre-petition collateral without the addition of other estate resources."

Marathon has failed to present any specific facts or even a possible theory as to where the almost $2 million transferred could have come from, if not from CapitalSource's cash collateral. Marathon concedes CapitalSource had perfected security interests in all of Debtor's personal property, including inventory, cash payments, rights to collections, and all proceeds thereof. When asked at oral argument "if there is anything in this record ... that creates a genuine issue of material fact" as to whether the funds were anything but CapitalSource's cash collateral Marathon's counsel admitted "I don't think there is anything in this record specifically on that point." Given those concessions and the evidence Cohen presented, we fail to see where else Debtor's cash could have come from other than the proceeds of its inventory, cash payments, or collections, in all of which CapitalSource had a security interest. Thus, Marathon's suggestion that there might have been some unidentified source of the deposit account funds that was beyond the ambit of CapitalSource's blanket lien is pure speculation and does not create a genuine issue of material fact.

In addition, Marathon also argues assuming that the funds constituted cash collateral Cohen may not avoid the payments because any violation of Section 363(c)(2) caused no harm to CapitalSource or the estate. Marathon asserts it gave equivalent value in inventory for the funds transferred to it by Debtor through a series of ordinary course transactions. Because CapitalSource admittedly had a perfected security interest in all of Debtor's personal property, Marathon claims CapitalSource's interests were not diminished when Debtor received equivalent value in petroleum products from Marathon in exchange for the funds.

But a "harmless" exception to a trustee's Section 549(a) avoiding powers does not exist. All Cohen needs to demonstrate to avoid the transfers under Section 549(a) is: (1) an unauthorized transfer occurred; (2) the property transferred was property of the estate; and (3) the transfer occurred post-petition. Section 549 does not require any analysis of the adequacy of protection of secured creditors' interests nor does it provide a harmless error exception. No genuine doubt exists that Debtor's transfers to Marathon were unauthorized because Debtor completed them without the permission of CapitalSource or the bankruptcy court in express violation Section 363(c)(2).

Finally, Marathon argues that as a matter of policy an implicit defense exists under Section 549 for ordinary course transfers and for innocent vendors who deal with a debtor-in-possession. These arguments do not persuade us. Congress's prohibition on the use of cash collateral in (c)(2) is a specific limitation on the express ability provided in (c)(1) to use estate property in the ordinary course of business. Congress evidently did not intend to allow the use of cash collateral without the permission of the interested secured creditor or the bankruptcy court, even if used in the ordinary course of business.

As to Marathon's status as an "innocent vendor," Sections 549(a) and 550(a) by their terms contain no reference to, let alone an actual defense based on, the transferee's status (vendor, purchaser, etc.) or upon its state of mind (innocent, culpable, etc.). Congress knew how to create exceptions based on transferee's status and culpability. But it chose not to do so when it came to

initial transferees of post-petition transfers of cash collateral. We will not create such exceptions in Congress's absence. AFFIRMED.

7.8. Post-Bankruptcy Financing

Money and credit are the life blood of a business. Without money or access to credit, the trustee (or the debtor-in-possession in a Chapter 11 case) cannot pay employees, cannot pay for utilities, supplies, additional inventory, or the other costs and expenses of the business, and the business will quickly die.

The Trustee or Debtor-in-possession has several potential sources of financing. First, the estate may have **free cash** – cash that is free of liens – which money can then be used in the ordinary course of business.

Second, as discussed in the last section, the estate may have prepetition cash (or collect prepetition accounts) on which a creditor has a security interest. This is cash collateral which can only be used with the secured creditor's consent, or the approval of the bankruptcy court upon a showing that the secured creditor is adequately protected. Consent to use cash collateral must first be sought from the secured creditor. If the creditor denies consent, then the trustee may seek permission from the court to use cash collateral over the secured creditor's objection.

Third, the estate may generate cash from the **sale of property post-petition**. That cash too may be restricted cash collateral if the property sold was subject to a security interest.

It is important to be able to determine whether cash from the sale of property is "free cash," or "cash collateral." If the property is sold and the cash is collected prepetition, state law will determine whether the secured creditors' lien attached to the proceeds. Under most security agreements, proceeds from the sale of collateral continue to be covered by the lien on the collateral.

Floating liens in bankruptcy raise special problems. A floating lien is a lien on collateral the constituency of which changes over time. For example, a lender may have a lien on all of the debtor's inventory. The particular items of inventory will change as inventory is sold, cash received, and new inventory purchased. Under most security agreements, any inventory purchased by the debtor after the loan is made will be subject to the lender's floating lien.

Section 552(a) of the Bankruptcy Code cuts off floating liens in bankruptcy, but contains an important exception that often swallows the rule. Under the general rule of Section 552(a), property acquired post-petition is not subject to a prepetition floating lien. Thus, inventory purchased by the debtor after bankruptcy would **not** be part of the prepetition secured creditor's security interest, as it would have before bankruptcy.

However, Section 552(b) contains a very important exception to the general rule. If so provided by the security agreement, proceeds, products, offspring, rents and property from prepetition collateral will continue to be covered by the prepetition security interest. Thus, if a creditor's prepetition security interest covers inventory and its proceeds, then sales of inventory will result in cash collateral proceeds, and the lien will also continue in any additional inventory purchased with the cash collateral (the new inventory will be proceeds of the cash collateral). Therefore, under Section 552, it is imperative to determine whether new collateral is purchased

with the estate's free cash (in which case the new inventory will not be subject to the lender's security interest), or is purchased with cash collateral (in which case the new inventory will be subject to the lender's security interest).

The rules of Section 552 play into cash collateral negotiations. When the debtor asks for consent to use cash collateral, the lender has a strong interest in assuring that its security interest will continue in the property purchased with the cash collateral, and that proper records are maintained to determine what property is covered by the lender's security interest and what property is not covered by the lender's security interest. If the sole source of funding for future inventory is cash collateral, the exercise is easy – the floating lien will continue post-petition. However, if the debtor has both free cash and cash collateral, it will be important to require careful recordkeeping of what is the lender's collateral (prepetition collateral and any collateral purchased with cash collateral), and what is not (property purchased with free cash).

Courts generally require the debtor-in-possession or trustee to attempt to negotiate a cash collateral stipulation with the secured creditor before asking for court authorization to use cash collateral. Only after good faith negotiations fail should a motion requesting authorization from the bankruptcy court be filed. Creditors who take unreasonable positions in cash collateral negotiations are often dealt with harshly when a request to use cash collateral comes before the court. This puts pressure on both the debtor and the creditors to negotiate a cash collateral stipulation in good faith.

Finally, the debtor may be able to borrow new money or obtain new credit on a secured or unsecured basis post-petition. Creditors who are willing to lend money or give the estate credit post-petition (often by selling goods to the trustee based on the estate's promise to make payment in the future) are given a special priority in bankruptcy. The Bankruptcy Code gives a creditor extending new **post-petition** credit an "administrative priority" over prepetition unsecured claims (and many other types of pre-petition priority claims). The new credit (whether in the form of a money loan or the provision of goods or services to be paid for in the future) is considered an "actual, necessary cost or expense of preserving the estate" under Section 503(b)(1)(A) of the Bankruptcy Code, and receives the second highest **unsecured** priority given to unsecured claims under Section 507(a)(2) of the Bankruptcy Code. The trustee can borrow money on an administrative priority basis in the ordinary course of business without bankruptcy court approval. 11 U.S.C. § 364(a). Incurring credit on an administrative basis outside of the ordinary course of business requires mere court approval, which is easily obtained (but requires a noticed motion and takes time). 11 U.S.C. § 364(b).

If creditors want more than an administrative claim in return for their post-petition loan of money or extension of credit, they must obtain court approval and make the showing required by the strictures of Section 364 of the Bankruptcy Code. Section 364 creates a hierarchy of requirements that must be met depending on what level of security the post-petition creditor requires. Each higher level requires a showing that needed credit is not available using the lower levels. Super administrative priority, a lien on property not already subject to a lien, or a junior lien on property subject to a lien is only available upon a showing that such credit would not be available on a grant of simple administrative priority. 11 U.S.C. § 364(c).

An equal or priming lien on property already subject to a lien is available only if the credit could not be obtained with an administrative or super administrative priority, or even with a lien

on unencumbered or junior lien on encumbered property. 11 U.S.C. § 364(d). In addition, the court must find that the secured creditor being equaled or primed is "adequately protected," a concept that we will study in more detail in Section 9.14. Equal or priming liens are harsh, and should not be granted unless there is ample equity to fully protect both the old and new secured creditors.

7.9. Practice Problems: Post-Petition Financing

Problem 1. Corporate Debtor operates a printing business. Its assets consist of printing presses, supplies of ink and paper, and some furniture. It fully utilized its $300,000 line of credit with PressBank, and when it asked for more money the Bank said "no." The Bank's line of credit is secured by a perfected first priority security interest in all of the Debtor's printing presses, supplies and furniture, worth about $200,000 in liquidation. The Debtor claims, however, that the property is worth "at least $400,000" in fair market value using the income that can be generated from the equipment in a going concern. After filing a petition under Chapter 11 of the Bankruptcy Code, the debtor-in-possession (with the powers of a trustee under Section 1107(a) of the Bankruptcy Code) searched high and low for financing without success. Only PrimeBank was willing to make the Debtor a $100,000 loan, but only if it would be given a first priority security interest in all of the Debtor's property ahead of PressBank. The Debtor filed a motion to obtain the **priming loan** needed to stay in business. With payroll due the next day, and a courtroom full of anxious employees, the Bankruptcy Court approved the priming lien over PressBank's objection, finding that the debtor's testimony regarding the going concern value to be "not sufficiently incredible enough to justify shutting down the business." The Bankruptcy Court denied PressBank's request for a stay pending appeal. The PrimeBank loan was funded the next day, the employees were paid, and the company continued to muddle along until the appellate court reversed the Bankruptcy Court's order, determining that there was insufficient evidence of equity to approve a priming lien. After the appellate court's decision, the Debtor's case was converted to Chapter 7 and the property liquidated by the trustee for $200,000. Who gets the money? *See* 11 U.S.C. § 364(e).

Problem 2. Debtor is a corporation in the business of making candles. The Trustee continued to operate the business after bankruptcy while looking to sell the business as a going concern. During the trustee's operations, one of the company's employees who was testing candles to determine the life of the flame knocked a burning candle into a pile of wicks, setting off an inferno that burned down the entire block of stores in which the factory was located. The neighbor stores filed administrative claims against the estate for the value of their buildings and inventory destroyed by the post-petition fire. The trustee objected, arguing that the damage caused by the fire was not an "actual, necessary cost or expense of preserving the estate" under Section 503(b)(1)(A) of the Bankruptcy Code. Indeed, argued the trustee, the fire and the damage done to the neighbors did not benefit the estate at all, and destroyed the debtor's business. Is the trustee right? *See Reading Co. v. Brown*, reprinted below.

7.10. Cases on Post-Petition Financing

7.10.1. IN RE SAYBROOK MANUFACTURING CO., INC., 963 F.2d 1490 (11th Cir. 1992)

Saybrook Manufacturing Co., Inc., initiated proceedings seeking relief under Chapter 11 of the Bankruptcy Code on December 22, 1988. On December 23, 1988, the debtors filed a motion for the use of cash collateral and for authorization to incur secured debt. The bankruptcy court entered an emergency financing order that same day. At the time the bankruptcy petition was filed, the debtors owed Manufacturers Hanover approximately $34 million. The value of the collateral for this debt, however, was less than $10 million. Pursuant to the order, Manufacturers Hanover agreed to lend the debtors an additional $3 million to facilitate their reorganization. In exchange, Manufacturers Hanover received a security interest in all of the debtors' property--both property owned prior to filing the bankruptcy petition and that which was acquired subsequently. This security interest not only protected the $3 million of post-petition credit but also secured Manufacturers Hanover's $34 million pre-petition debt.

This arrangement enhanced Manufacturers Hanover's position vis-a-vis other unsecured creditors, such as the Shapiros, in the event of liquidation. Because Manufacturers Hanover's pre-petition debt was undersecured by approximately $24 million, it originally would have shared in a pro rata distribution of the debtors' unencumbered assets along with the other unsecured creditors. Under the financing order, however, Manufacturers Hanover's pre-petition debt became fully secured by all of the debtors' assets. If the bankruptcy estate were liquidated, Manufacturers Hanover's entire debt--$34 million pre-petition and $3 million post-petition--would have to be paid in full before any funds could be distributed to the remaining unsecured creditors.

Securing pre-petition debt with pre- and post-petition collateral as part of a post-petition financing arrangement is known as cross-collateralization, [or *Texlon* Cross Collateralization because it was first defined in *In re Texlon Corp*. 596 F.2d 1092, 1094 (2d Cir.1979). Another form of cross-collateralization involves securing post-petition debt with pre-petition collateral. This form of non-*Texlon*-type cross-collateralization is not at issue in this appeal. The Shapiros challenge only the cross-collateralization of the lenders' pre-petition debt, not the propriety of collateralizing the post-petition debt.

The Shapiros [who were unsecured creditors of the Debtor] filed a number of objections to the bankruptcy court's order on January 13, 1989. After a hearing, the bankruptcy court overruled the objections. The Shapiros then filed a notice of appeal and a request for the bankruptcy court to stay its financing order pending appeal. The bankruptcy court denied the request for a stay on February 23, 1989. The Shapiros subsequently moved the district court to stay the bankruptcy court's financing order pending appeal; the court denied the motion on March 7, 1989. On May 20, 1989, the district court dismissed the Shapiros' appeal as moot under 11 U.S.C. § 364(e) because the Shapiros had failed to obtain a stay of the financing order pending appeal, rejecting the argument that cross-collateralization is contrary to the Code. The Shapiros then appealed to this court.

The lenders argue that this appeal is moot under section 364(e) of the Bankruptcy Code. That section provides that a lien or priority granted under section 364 may not be overturned unless

it is stayed pending appeal. Even if this appeal were not moot, the Shapiros are not entitled to relief. Cross-collateralization is a legitimate means for debtors to obtain necessary financing and is not prohibited by the Bankruptcy Code.

The Shapiros contend that their appeal is not moot. Because cross-collateralization is not authorized under bankruptcy law, section 364(e) is inapplicable. Permitting cross-collateralization would undermine the entire structure of the Bankruptcy Code by allowing one unsecured creditor to gain priority over all other unsecured creditors simply by extending additional credit to a debtor.

We begin by addressing the lenders' claim that this appeal is moot under section 364(e) of the Bankruptcy Code. The purpose of this provision is to encourage the extension of credit to debtors in bankruptcy by eliminating the risk that any lien securing the loan will be modified on appeal.

The lenders suggest that we assume cross-collateralization is authorized under section 364 and then conclude the Shapiros' appeal is moot under section 364(e). This is similar to the approach adopted by the Ninth Circuit in *In re Adams Apple, Inc.*, 829 F.2d 1484 (9th Cir.1987). That court held that cross-collateralization was "authorized" under section 364 for the purposes of section 364(e) mootness but declined to decide whether cross-collateralization was illegal per se under the Bankruptcy Code.

We reject the reasoning of *In re Adams Apple* because they "put the cart before the horse." By its own terms, section 364(e) is only applicable if the challenged lien or priority was authorized under section 364. We cannot determine if this appeal is moot under section 364(e) until we decide the central issue in this appeal--whether cross-collateralization is authorized under section 364. Accordingly, we now turn to that question.

Cross-collateralization is an extremely controversial form of Chapter 11 financing. Nevertheless, the practice has been approved by several bankruptcy courts. Even the courts that have allowed cross-collateralization, however, were generally reluctant to do so. [The bankruptcy court in *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr.E.D.N.Y.1983)], held that in order to obtain a financing order including cross-collateralization the debtor [must] demonstrate (1) that its business operations would fail absent the proposed financing, (2) that it is unable to obtain alternative financing on acceptable terms, (3) that the proposed lender will not accept less preferential terms, and (4) that the proposed financing is in the general creditor body's best interest.

The issue of whether the Bankruptcy Code authorizes cross-collateralization is a question of first impression in this court. Indeed, it is essentially a question of first impression before any court of appeals. Neither the lenders' brief nor our own research has produced a single appellate decision which either authorizes or prohibits the practice. [The court noted that the prior appellate decisions ruled that the appeals were moot without deciding whether cross-collateralization is permissible].

The Second Circuit expressed criticism of cross-collateralization in *In re Texlon*. The court, however, stopped short of prohibiting the practice altogether. At issue was the bankruptcy court's ex parte financing order granting the lender a security interest in the debtor's property to secure both pre-petition and post-petition debt. The court, in an exercise of judicial restraint, concluded that:

> In order to decide this case we are not obliged, however, to say that under no conceivable circumstances could "cross-collateralization" be authorized. Here it suffices to hold that ... a financing scheme so contrary to the spirit of the Bankruptcy Act should not have been granted by an ex parte order, where the bankruptcy court relies solely on representations by a debtor in possession that credit essential to the maintenance of operations is not otherwise obtainable.

In re Texlon, 596 F.2d at 1098. Although *In re Texlon* was decided under the earlier Bankruptcy Act, the court also considered whether cross-collateralization was authorized under the Bankruptcy Code. "To such limited extent as it is proper to consider the new Bankruptcy Act, which takes effect on October 1, 1979, in considering the validity of an order made in 1974, we see nothing in § 364(c) or in other provisions of that section that advances the case in favor of 'cross-collateralization.' "*In re Texlon*, 596 F.2d at 1098 (citations omitted).

Cross-collateralization is not specifically mentioned in the Bankruptcy Code. We conclude that cross-collateralization is inconsistent with bankruptcy law for two reasons. First, cross-collateralization is not authorized as a method of post-petition financing under section 364. Second, cross-collateralization is beyond the scope of the bankruptcy court's inherent equitable power because it is directly contrary to the fundamental priority scheme of the Bankruptcy Code.

Given that cross-collateralization is not authorized by section 364, we now turn to the lenders' argument that bankruptcy courts may permit the practice under their general equitable power. Bankruptcy courts are indeed courts of equity, and they have the power to adjust claims to avoid injustice or unfairness. This equitable power, however, is not unlimited. [T]he bankruptcy court has the ability to deviate from the rules of priority and distribution set forth in the Code in the interest of justice and equity. The Court cannot use this flexibility, however, merely to establish a ranking of priorities within priorities. Furthermore, absent the existence of some type of inequitable conduct on the part of the claimant, which results in injury to the creditors of the bankrupt or an unfair advantage to the claimant, the court cannot subordinate a claim to claims within the same class.

Section 507 of the Bankruptcy Code fixes the priority order of claims and expenses against the bankruptcy estate. 11 U.S.C. § 507. Creditors within a given class are to be treated equally, and bankruptcy courts may not create their own rules of superpriority within a single class. Cross-collateralization, however, does exactly that. As a result of this practice, post-petition lenders' unsecured pre-petition claims are given priority over all other unsecured pre-petition claims. The Ninth Circuit recognized that "[t]here is no ... applicable provision in the Bankruptcy Code authorizing the debtor to pay certain pre-petition unsecured claims in full while others remain unpaid. To do so would impermissibly violate the priority scheme of the Bankruptcy Code." The fundamental nature of this practice is not changed by the fact that it is sanctioned by the bankruptcy court. We disagree with the district court's conclusion that, while cross-collateralization may violate some policies of bankruptcy law, it is consistent with the general purpose of Chapter 11 to help businesses reorganize and become profitable. Rehabilitation is certainly the primary purpose of Chapter 11. This end, however, does not justify the use of any means. Cross-collateralization is directly inconsistent with the priority scheme of the Bankruptcy Code. Accordingly, the practice may not be approved by the bankruptcy court under its equitable authority.

Cross-collateralization is not authorized by section 364. Section 364(e), therefore, is not applicable and this appeal is not moot. Because *Texlon* -type cross-collateralization is not explicitly authorized by the Bankruptcy Code and is contrary to the basic priority structure of the Code, we hold that it is an impermissible means of obtaining post-petition financing. The judgment of the district court is REVERSED and the case is REMANDED for proceedings not inconsistent with this opinion.

7.10.2. READING v. BROWN, 391 U.S. 471 (1968)

MR. JUSTICE HARLAN delivered the opinion of the Court.

On November 16, 1962, I. J. Knight Realty Corporation filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. The same day, the District Court appointed a receiver, Francis Shunk Brown, a respondent here. The receiver was authorized to conduct the debtor's business, which consisted principally of leasing the debtor's only significant asset, an eight-story industrial structure located in Philadelphia.

On January 1, 1963, the building was totally destroyed by a fire which spread to adjoining premises and destroyed real and personal property of petitioner Reading Company and others. On April 3, 1963, petitioner filed a claim for $559,730.83 in the arrangement, based on the asserted negligence of the receiver. It was styled a claim for "administrative expenses" of the arrangement. Other fire loss claimants filed 146 additional claims of a similar nature. The total of all such claims was in excess of $3,500,000, substantially more than the total assets of the debtor.

On May 14, 1963, Knight Realty was voluntarily adjudicated a bankrupt, and respondent receiver was subsequently elected trustee in bankruptcy. The claims of petitioner and others thus became claims for administration expenses in bankruptcy, which are given first priority under § 64a(1) of the Bankruptcy Act. The trustee moved to expunge the claims on the ground that they were not for expenses of administration. It was agreed that the decision whether petitioner's claim is provable as an expense of administration would establish the status of the other 146 claims. It was further agreed that, for purposes of deciding whether the claim is provable, it would be assumed that the damage to petitioner's property resulted from the negligence of the receiver and a workman he employed.

Section 64a of the Bankruptcy Act provides in part as follows: "The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition. . . ."

The question in this case is whether the negligence of a receiver administering an estate under a Chapter XI arrangement gives rise to an "actual and necessary" cost of operating the debtor's business. The Act does not define "actual and necessary," nor has any case directly in point been brought to our attention. We must, therefore, look to the general purposes of § 64a, Chapter XI, and the Bankruptcy Act as a whole.

The trustee contends that the relevant statutory objectives are (1) to facilitate rehabilitation of insolvent businesses and (2) to preserve a maximum of assets for distribution among the general creditors should the arrangement fail. He therefore argues that first priority as "necessary"

expenses should be given only to those expenditures without which the insolvent business could not be carried on. For example, the trustee would allow first priority to contracts entered into by the receiver because suppliers, employees, landlords, and the like would not enter into dealings with a debtor in possession or a receiver of an insolvent business unless priority is allowed. The trustee would exclude all negligence claims, on the theory that first priority for them is not necessary to encourage third parties to deal with an insolvent business, but that first priority would reduce the amount available for the general creditors, and that first priority would discourage general creditors from accepting arrangements.

In our view, the trustee has overlooked one important, and here decisive, statutory objective: fairness to all persons having claims against an insolvent. Petitioner suffered grave financial injury from what is here agreed to have been the negligence of the receiver and a workman. It is conceded that, in principle, petitioner has a right to recover for that injury from their "employer," the business under arrangement, upon the rule of respondeat superior. Respondents contend. However, that petitioner is in no different position from anyone else injured by a person with scant assets: its right to recover exists in theory but is not enforceable in practice.

That, however, is not an adequate description of petitioner's position. At the moment when an arrangement is sought, the debtor is insolvent. Its existing creditors hope that, by partial or complete postponement of their claims they will through successful rehabilitation, eventually recover from the debtor either in full or in larger proportion than they would in immediate bankruptcy. Hence, the present petitioner did not merely suffer injury at the hands of an insolvent business: it had an insolvent business thrust upon it by operation of law. That business will, in any event, be unable to pay its fire debts in full. But the question is whether the fire claimants should be subordinated to, should share equally with, or should collect ahead of those creditors for whose benefit the continued operation of the business (which unfortunately led to a fire instead of the hoped-for rehabilitation) was allowed.

In any event, we see no reason to indulge in a strained construction of the relevant provisions, for we are persuaded that it is theoretically sounder, as well as linguistically more comfortable, to treat tort claims arising during an arrangement as actual and necessary expenses of the arrangement, rather than debts of the bankrupt. In the first place, in considering whether those injured by the operation of the business during an arrangement should share equally with, or recover ahead of, those for whose benefit the business is carried on, the latter seems more natural and just. Existing creditors are, to be sure, in a dilemma not of their own making, but there is no obvious reason why they should be allowed to attempt to escape that dilemma at the risk of imposing it on others equally innocent.

More directly in point is the possibility of insurance. An arrangement may provide for suitable coverage, and the court below recognized that the cost of insurance against tort claims arising during an arrangement is an administrative expense payable in full under § 64a(1) before dividends to general creditors. It is, of course, obvious that proper insurance premiums must be given priority, else insurance could not be obtained, and if a receiver or debtor in possession is to be encouraged to obtain insurance in adequate amounts, the claims against which insurance is obtained should be potentially payable in full. In the present case, it is argued, the fire was of such incredible magnitude that adequate insurance probably could not have been obtained and, in any event, would have been foolish; this may be true, as it is also true that allowance of a first priority to the fire claimants here will still only mean recovery by them of a fraction of their damages. In

the usual case where damages are within insurable limits, however, the rule of full recovery for torts is demonstrably sounder.

Although there appear to be no cases dealing with tort claims arising during Chapter XI proceedings, decisions in analogous cases suggest that "actual and necessary costs" should include costs ordinarily incident to operation of a business, and not be limited to costs without which rehabilitation would be impossible. It has long been the rule of equity receiverships that torts of the receivership create claims against the receivership itself; in those cases, the statutory limitation to "actual and necessary costs" is not involved, but the explicit recognition extended to tort claims in those cases weighs heavily in favor of considering them within the general category of costs and expenses.

In some cases arising under Chapter XI, it has been recognized that "actual and necessary costs" are not limited to those claims which the business must be able to pay in full if it is to be able to deal at all. For example, state and federal taxes accruing during a receivership have been held to be actual and necessary costs of an arrangement.] The United States, recognizing and supporting these holdings, agrees with petitioner that costs that form "an integral and essential element of the continuation of the business" are necessary expenses even though priority is not necessary to the continuation of the business. Thus, the Government suggests that "an injury to a member of the public -- a business invitee -- who was injured while on the business premises during an arrangement would present a completely different problem [i.e., could qualify for first priority]," although it is not suggested that, priority is needed to encourage invitees to enter the premises.

The United States argues, however, that each tort claim "must be analyzed in its own context." Apart from the fact that it has been assumed throughout this case that all 147 claimants were on an equal footing and it is not very helpful to suggest here for the first time a rule by which lessees, invitees, and neighbors have different rights, we perceive no distinction: no principle of tort law of which we are aware offers guidance for distinguishing, within the class of torts committed by receivers while acting in furtherance of the business, between those "integral" to the business and those that are not.

We hold that damages resulting from the negligence of a receiver acting within the scope of his authority as receiver give rise to "actual and necessary costs" of a Chapter XI arrangement.

7.10.3. IN RE RESOURCES TECHNOLOGY CORP., 662 F.3d 472, 474 (7th Cir. 2011)

POSNER, Circuit Judge.

Roti owned a Holiday Inn in a Chicago suburb. The hotel was adjacent to a landfill owned and operated by CDC. Back in 1996 CDC had hired RTC to build a system for preventing the methane, carbon dioxide, hydrogen sulfide, and other gases generated in the landfill from leaking; the system would also extract energy from the gas, which RTC would sell, paying CDC a royalty. So: a gas collection and control system.

In 1999 RTC was forced into bankruptcy under Chapter 11 (reorganization). Roti bought the Holiday Inn three years later, and in 2005 it followed RTC into Chapter 11, though for

unrelated reasons. RTC's Chapter 11 bankruptcy was converted to a Chapter 7 bankruptcy (liquidation) in September 2005. A trustee was appointed on September 21 to operate the debtor's business until the liquidation was complete. Four days after the trustee was given operational control of RTC's business en route to liquidation, RTC's gas collection and control system at CDC's landfill failed; it had been malfunctioning for years and RTC had lacked the financial wherewithal to fix it. The system's failure released foul odors that, traveling underground, wafted into the hotel through electrical outlets and floor cracks. The odors sickened guests and employees, resulting (according to Roti) in a disastrous fall off in the hotel's business.

In September 2006 Roti sold the Holiday Inn for $5 million. He claims that had it not been for the odors, he could have sold it for almost five times as much; his claim against RTC in the bankruptcy court is for the difference. (The reason it is his claim, rather than the claim of the LLC that owned the Holiday Inn, is that Roti, the sole member of the LLC, caused the company's claim to be assigned to him.)

The bankrupt estate has other creditors besides Roti. But he contends that his claim is an administrative claim that trumps the claims of the other creditors (with at least one exception, as we're about to note). Administrative expenses, which consist of the "actual, necessary costs and expenses of preserving the [bankrupt] estate," receive priority in the distribution of the estate's assets to creditors. 11 U.S.C. §§ 503(b)(1)(A), 507(a)(2).

The trustee had been operating RTC's system for only four days before the failure occurred. The failure resulted from the many years of RTC's neglect, and there is no evidence that the trustee was aware of that neglect, did anything to exacerbate it, could have done anything to prevent the failure triggered by that neglect within the few days in which he was in nominal control of the system before it failed, or could have done anything to mitigate the damage afterward.

Roti is right to note the oddity of a tort without a suable tortfeasor, but the fact that the Chapter 11 estate is not suable, nor the trustee in his personal capacity, still leaves the Chapter 7 estate as the suable party. Roti does have a claim against the bankrupt estate, and that makes him a creditor, yet he is not asking, as an alternative to the recognition of his administrative claim, that he be dumped in with the general creditors; for him it is administrative claim or nothing, which is doubtless why the district court stopped with ruling that he has no administrative claim.

The reason administrative claims are given priority is that they are claims for reimbursement by the bankrupt estate of expenses incurred after the declaration of bankruptcy, in order to preserve and if possible enhance the value of the bankrupt estate for the benefit of its creditors. A tort victim (Roti) is a creditor, but not a creditor whose actions benefit his debtor, the tortfeasor. Yet in *Reading v. Brown*, 391 U.S. 471 (1968), the Supreme Court held that at least in a Chapter 11 bankruptcy, tort claims arising from the continued operation of the bankrupt business should be treated as administrative claims, like other post-petition expenses. Tort liability is an expense of doing business, like labor or material costs, and should be treated the same way. Businesses operating in bankruptcy that were excused from tort liability would have an inefficient competitive advantage over their solvent competitors—and deficient incentives to use due care in the operation of the business. It could indeed be argued that in the interest of safety, insolvent firms, not being deferrable by threat of tort suits, should not be allowed to operate at all. *Reading* strikes a compromise between the safety interest and the interest in saving bankrupts from

premature liquidation: the bankrupt that continues to operate (normally under Chapter 11) must give its tort victims priority access to such assets as the bankrupt estate retains.

RTC was in Chapter 7 bankruptcy when the tort occurred; can the principle of *Reading* be extended to Chapter 7, given that the goal of such a bankruptcy is liquidation of the bankrupt's assets at the highest possible price rather than the continuation of the bankrupt's business? Sometimes yes; for the dichotomy between operation and liquidation is too stark. There is an interval between the appointment of the trustee and the liquidation of the bankrupt's assets under his supervision, and during that interval he may have operating responsibilities. The policy that supports the *Reading* doctrine—the policy against permitting bankrupt firms to externalize the costs of their torts—depends on whether the bankrupt firm is operating, not which part of the Bankruptcy Code (that is, whether Chapter 7 or Chapter 11) it is operating under.

But at least as far as the gas collection and control system in CDC's landfill was concerned, the bankrupt in this case was not operating in any meaningful sense during the brief period in which the trustee was in charge. It had some minute revenue from energy sales—less than 10 percent of its normal revenue from such sales—but it is doubtful that this revenue covered its costs, or that the continued operation of the system in its diminished state can be attributed to anything other than the bankrupt's legal duty to minimize further contamination.

We thus are far from *Reading*, where the Chapter 11 receiver (equivalent to a trustee) was managing a building that was the debtor's principal asset, when the building burned down and in the process caused damage to adjacent buildings, triggering tort claims against the bankrupt estate. The receiver was either collecting rents or otherwise obtaining or attempting to obtain income for the estate from the building, and by doing so he was unavoidably running a risk of fire. In this case, in contrast, the trustee took over a bankrupt company at the point of collapse, and the collapse was unrelated to his control of the assets. He had neither the mandate nor the resources to do anything with them except liquidate them as quickly as possible, which he proceeded to do. He could and did do nothing with the assets that might (with however low a probability) have enhanced their value for the creditors, in which event they would have had to take the bad with the good—the risk of tort liability along with the prospects for successful management of the assets. The trustee operated a losing venture under legal compulsion. There is no basis for applying the doctrine of *Reading* to such a case.

7.11. Executory Contracts and Unexpired Leases – Assumption and Rejection

Professor Vern Countryman defined an executory contract in a famous law review article as follows:

> "A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."

EXECUTORY CONTRACTS IN BANKRUPTCY: PART I, 57 Minn. L. Rev. 439, 460 (1973). Countryman's definition has stood the test of time as a touchstone, but has not been accepted by

all courts. Some courts have used the so-called "functional" test to define whether a contract is executory: "whether assumption or rejection of the contract in question would benefit the debtor's estate." *In re Worldcom*, 343 B.R. 486 (Bankr. S.D.N.Y. 2006). If assumption or rejection would benefit the estate, then it's an executory contract, if not it's not.

Incomplete contracts pose special problems in bankruptcy. The basic concept underlying Section 365 of the Bankruptcy Code is that the trustee should be able to choose whether the estate will assume the contract (and thus be administratively liable for performance – breach will result in an administrative claim), or whether the estate should reject the contract (and thus limit the other party to a general unsecured claim for damages for breach). *See* 11 U.S.C. § 365(g) (rejection constitutes breach immediately before bankruptcy, resulting in prepetition claim).

Section 365 also incorporates the idea that the trustee needs time to decide whether the executory contract is beneficial to the estate (and thus should be assumed) or burdensome (and thus should be rejected). Courts have consistently held that it is a violation of the automatic stay for a counter-party to terminate an executory contract before it has been rejected. *See e.g*. *In re Lavigne*, 114 F.3d 379, 386-88 (2d Cir. 1997); and *In re Computer Communications, Inc*., [reprinted below].

Because the automatic stay requires the other party to the executory contract to continue performing while awaiting the trustee's decision to assume or reject, the counter-party should be entitled to know within a reasonable period of time whether a return performance will be forthcoming. Congress has seen fit to protect some executory counter-parties by setting deadlines for assumption or rejection (after which the contract will be deemed rejected), while leaving other counter parties to fend for themselves (by asking the bankruptcy court for protection, to be granted in the bankruptcy court's discretion). *See* 11 U.S.C. § 365(d) (setting time periods for assumption in certain circumstances), and 365(d)(2) (court "may order the trustee to determine within a specified period of time whether to assume or reject").

Intertwined with the concept of assumption and rejection is the question of the effect of rejection – does rejection only determine the priority of the executory counter-party's damage claim, or does rejection terminate the non-debtor party's substantive rights under the contract? The effect of rejection is a lengthy and complex topic involving many grey areas rather than clearly defined lines. Congress suggested that rejection does terminate the other contracting party's rights by enacting a special exception allowing tenants of a bankrupt landlord (or an installment sale purchaser) to retain possessory rights after rejection. *See* 11 U.S.C. § 365(h), (I). Congress's suggestion was adopted in the controversial case of *Lubrizol Enterprises Inc. v. Richmond Finishers Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985), where the Fourth Circuit held that the rejection of an executory **license** allowed the debtor to terminate the licensee's rights. Congress responded to *Lubrizol* by creating additional special exceptions allowing an "intellectual property" licensee to retain license rights after rejection. *See* 11 U.S.C. § 365(n). However, the definition of "intellectual property" in Section 101(35A) does not cover all intellectual property, including trademarks. Courts have been struggling with whether rejection of a trademark terminates the other contracting-party's right to use the mark.

Prior to the decision in *Exide Technologies*, reprinted below, there was great disagreement about whether rejection terminates the other counter-party's contractual property rights in the absence of a statutory exception. *Compare In re Lavigne*, 114 F.3d 379, 386- 88 (2d Cir. 1997);

Michael T. Andrew, EXECUTORY CONTRACTS IN BANKRUPTCY: UNDERSTANDING "REJECTION," 59 U.Colo.L.Rev. 845 (1988); *In re The Drexel Burnham Lambert Group*, 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992) ("[r]ejection merely frees the estate from the obligation to perform; it does not make the contract disappear.") with *In re Centura Software Corp.*, 281 B.R. 660 (Bankr. N.D. Cal. 2002) (rejection terminates trademark license). That question has now been settled by the Supreme Court.

Section 365 deals with both executory contracts and unexpired leases. Not all documents called leases are subject to Section 365. The law has long recognized that financing transactions can be disguised as leases. If the entire useful life of the property will be used up during the lease term, or if the "lessor" has the right to buy the property for significantly less than it is expected to be worth at the end of the lease term, then the transaction is really a financed sale and not a true lease subject to Section 365. *See In re Integrated Health Services, Inc.*, 260 B.R. 71, 75-76 (Bankr. Del. 2001). Only true leases (where the lessee is expected to return the property to the lessor at the end of the lease term) are governed by Section 365.

7.12. What is an Executory Contract?

7.12.1. IN RE EXIDE TECHNOLOGIES, 607 F.3d 957 (3d Cir. 2010)

[This case was decided before the Supreme Court held in the *Mission Products Holding* case that rejection of a trademark licensing agreement does not terminate the licensee's rights to use the mark.]

After filing for bankruptcy, Exide sought to reject various agreements that it had with EnerSys arising from their June 1991 transaction. In June 1991, Exide sold substantially all of its industrial battery business to EnerSys for about $135 million. The assets that Exide sold to EnerSys included physical manufacturing plants, equipment, inventory, and certain items of intellectual property. To formalize the sale, Exide and EnerSys entered into over twenty-three agreements. The Bankruptcy Court held that the four agreements constituted a single integrated Agreement (the Agreement). Neither Exide nor EnerSys have challenged this determination. We therefore take the next step of determining whether the Agreement is an executory contract.

Under the Agreement, Exide licensed its "Exide" trademark to EnerSys for use in the industrial battery business. Exide wanted to continue to use the Exide mark outside of the industrial battery business. To accommodate the needs of both parties, Exide granted EnerSys a perpetual, exclusive, royalty-free license to use the Exide trademark in the industrial battery business. This division worked, and, for almost ten years, each party appeared satisfied with the results of the transaction.

In 2000, however, Exide expressed a desire to return to the North American industrial battery market. After the parties agreed to the early termination of a ten-year noncompetition Agreement (thus granting Exide permission to reenter the market), Exide made several attempts to regain the trademark from EnerSys, but EnerSys refused. Exide wanted to regain the mark as a part of its strategic goal to unify its corporate image. Exide hoped to use a single name and

trademark on all the products that it produced; this single name and trademark were, naturally, "Exide."

Exide reentered the industrial battery business by purchasing GNB Industrial Battery Company. Exide, however, remained bound by the ongoing obligation to forbear from using the Exide trademark in that business for as long as the license continued in effect. Thus, from 2000 until Exide filed for bankruptcy protection in 2002, Exide was forced to compete directly against EnerSys, which was selling batteries under the name "Exide." Then, when Exide filed for bankruptcy under Chapter 11, Exide was presented the opportunity to try to regain the Exide trademark by rejecting the Agreement. Exide sought the Bankruptcy Court's approval to do so.

The policy behind Chapter 11 of the Bankruptcy Code is the "ultimate rehabilitation of the debtor." The Code therefore allows debtors in possession, "subject to the court's approval, ... [to] reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). But the Bankruptcy Code does not define "executory contract." Relevant legislative history demonstrates that Congress intended the term to mean a contract "on which performance is due to some extent on both sides."

With congressional intent in mind, this Court has adopted the following definition: "`An executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'" "Thus, unless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under § 365." The party seeking to reject a contract bears the burden of demonstrating that it is executory. And "[t]he time for testing whether there are material unperformed obligations on both sides is when the bankruptcy petition is filed." Finally, to conduct this determination, we "consider contract principles under relevant nonbankruptcy law." New York, because it is the forum selected in the Agreement's choice-of-law provision, provides the relevant nonbankruptcy law.

Accordingly, our inquiry is to determine whether the Agreement, on April 15, 2002, contained at least one obligation for both Exide and EnerSys that would constitute a material breach under New York law if not performed. If not, then the Agreement is not an executory contract.

Under New York law, a material breach, which "justif[ies] the other party to suspend his own performance," is "a breach which is so substantial as to defeat the purpose of the entire transaction."

[U]nder New York law, only a breach in a contract which substantially defeats the purpose of that contract can be grounds for rescission. The non-breaching party will be discharged from the further performance of its obligations under the contract when the breach goes to the root of the contract.

But when a breaching party "has substantially performed" before breaching, "the other party's performance is not excused."

New York's high court has instructed how to determine when a party has rendered substantial performance:

> There is no simple test for determining whether substantial performance has been rendered and several factors must be considered, including the ratio of the performance already rendered to that unperformed, the quantitative character of the default, the degree to which the purpose behind the contract has been frustrated, the willfulness of the default, and the extent to which the aggrieved party has already received the substantial benefit of the promised performance.

Hadden, 356 N.Y.S.2d 249, 312 N.E.2d at 449. "The issue of whether a party has substantially performed is usually a question of fact and should be decided as a matter of law only where the inferences are certain."

The Bankruptcy Court here failed to properly measure whether either party had substantially performed. Our inspection of the record, however, reveals that the inferences are clear that EnerSys has substantially performed. Applying Hadden's balancing test, EnerSys's performance rendered outweighs its performance remaining and the extent to which the parties have benefitted is substantial. Specifically, EnerSys has substantially performed by paying the full $135 million purchase price and operating under the Agreement for over ten years. EnerSys has been producing industrial batteries since 1991, using all the assets transferred under the Agreement, including real estate, real-estate leases, inventory, equipment and the right to use the trademark "Exide." Moreover, EnerSys has provided Exide with the substantial benefit of assuming the latter's liabilities, including numerous contracts and accounts receivable, within the business EnerSys purchased.

Exide argues that EnerSys's ongoing, unperformed obligations outweigh its performance. It relies on the following four obligations of EnerSys: (1) an obligation to satisfy the Quality Standards Provision, and obligations to observe (2) the Use Restriction, (3) the Indemnity Obligations, and (4) the Further Assurances Obligations.[4] We reject Exide's argument; these four obligations do not outweigh the substantial performance rendered and benefits received by EnerSys.

First, EnerSys's obligation to observe the Use Restriction, i.e., not to use the Trademark outside the industrial battery business, is not a material obligation because it is a condition subsequent that requires EnerSys to use the mark in accordance with the terms of the Trademark License. A condition subsequent is not a material obligation. Moreover, the Use Restriction does not relate to the purpose of the Agreement — which is that Exide would transfer its industrial battery business and the concomitant assets and liabilities to EnerSys and EnerSys in exchange would pay Exide about $135 million. Therefore, even if the obligation were not a condition subsequent, it nevertheless would not affect the substantial performance of the Agreement.

Second, EnerSys's obligation to observe the Quality Standards Provision is minor because it requires meeting the standards of the mark for each battery produced; it does not relate to the transfer of the industrial battery business.

Finally, the other two obligations that Exide argues are substantial, the Indemnity Obligation and the Further Assurances Obligation, do not outweigh the factors supporting substantial performance. In regard to the Indemnity Obligation, under the Asset Purchase Agreement, all representations and warranties arising from it expired in 1994, on the third

anniversary of the closing and Exide did not present any evidence that any liability assumed by EnerSys was still pending. Similarly, under the Further Assurances Obligation, EnerSys agreed to cooperate to facilitate the 1991 transaction. Exide has identified no remaining required cooperation.

Exide argues, however, citing *Hadden*, that the substantial-performance doctrine is "irrelevant here" because it applies only in cases involving construction or employment contracts. Our review of New York law reveals that no New York court has held (or even intimated) that the doctrine should be confined to the construction/employment contract areas. Indeed, the Second Circuit Court of Appeals, applying New York law, recently applied Hadden's substantial-performance doctrine in a $490 million asset-purchase contract that formalized the sale of an energy trading commodities business to a larger energy business. That contract was neither a construction nor employment contract. We also now conclude that we will not confine the doctrine to construction and employment contract cases.

For the reasons stated above, we have determined that the Agreement is not an executory contract because it does not contain at least one ongoing material obligation for EnerSys. Because the Agreement is not an executory contract, Exide cannot reject it. We will vacate the District Court's order and remand this case to it for remand to the Bankruptcy Court for further proceedings consistent with this opinion.

7.12.2. RIESER v. DAYTON COUNTRY CLUB CO., 972 F.2d 689 (6th Cir. 1992)

In this case we are asked to review an order barring a trustee in bankruptcy under Chapter 7 from assuming and assigning a golf membership in a country club as an executory contract, pursuant to section 365 of the Bankruptcy Code. 11 U.S.C. § 365.

The Dayton Country Club is an organization, in the form of a corporation, consisting of several hundred individuals who have joined together for recreation and entertainment. Its shares of stock may be held only by the members of the club and may not be accumulated in any substantial amount by one member.

Since there was only one 18-hole golf course available, the maximum number of members eligible to play golf needed to be limited in order to make the playing of the game enjoyable to those playing. There was no need to so limit the number of members who could use the tennis courts, the pool, the restaurants, or who could enjoy the social events of the club. The club developed within its membership a special membership category for those who had full golfing privileges. This category was limited to 375 members. Detailed rules, procedures, and practices were developed to ensure the fair selection of golfing members. These rules, procedures, and practices define how this additional privilege is allocated, how the number of members is maintained at 375, how vacancies occur, how they are filled, and what additional fees are charged.

If a member desires to play golf, he or she asks to become a golfing member in one of several golf membership categories. When he or she makes this request, an additional substantial fee is paid to the club and the individual is placed on a waiting list. At the time the record was made in this case, there were about 70 persons on that list. When a vacancy occurs because of a

failure to pay dues or a resignation, the first person on the waiting list is given the option to become a golfing member by paying an additional substantial fee. Upon becoming a golfing member, the monthly dues also increase substantially. If the person at the top of the waiting list declines the membership, then that person is placed at the bottom of the list and the next person on the list is given the opportunity to become a golfing member. There is no provision for any person to assign or sell the golf membership to any other person or for any person to become a golfing member in any other way except in two intimate and personal situations dealt with in discrete ways. When the death of a golfing member occurs, a spouse (who had been enjoying the hospitality of the club) may take the deceased member's place. If a divorce occurs, the member may designate his or her spouse as the golfing member.

The nature of the golf membership within the overall club membership is the heart of this case. We are not dealing with the right to be a member of the club and there is nothing in this case relating to laws and social policies against discrimination. The issues in this case relate solely to the rights, duties, and privileges of the club and its members arising from the club's effort to provide golfing privileges to some but not all of its members, and the effect of the bankruptcy laws upon that effort.

[Two bankruptcy debtors, Magness and Redman,] were golfing members of the Dayton Country Club. The trustee in bankruptcy sought to assume and assign, through sale, the rights under these memberships to (1) members on the waiting list, (2) other club members, or (3) the general public, provided that the purchaser first obtains membership in the Dayton Country Club. In other words, the trustee seeks to increase the value of the bankruptcy estate by taking value for and assigning to others a relationship between the bankrupt and the club. The assignment would be to the detriment of other club members who had paid for and acquired the right to become golfing members in due course. The question is whether the trustee has the right to make the assignment.

It is not inappropriate to think of these contracts as creating a type of property interest. The full golf membership and the rights that come from that relationship with the club can be described as a property right of that member, the parameters of which are defined by the rules, procedures, and practices of the club. These rules, procedures, and practices, and therefore the extent of the members' property interest, do not extend to any right on the members' part to pass on the membership to others, except in in death or divorce. The persons on the waiting list also can be described as having a type of property interest in the relationships described in their contracts with the club. Theirs is a lesser interest than that of the full golfing members, but a real one nonetheless. They have paid the club for the right to be considered in the numbered order on the list to become full golfing members as vacancies occur. They, like the full golfing members, have a status defined by the various rules, procedures, and practices pertaining to filling the membership roster.

The bankruptcy courts found, and the district court affirmed, that the full golf memberships are executory contracts under § 365 of the Bankruptcy Code. Section 365(f)(1) of the Bankruptcy Code provides that executory contracts may be assigned notwithstanding non-assignment provisions in the contract or the law: Section 365(c)(1) contains an exception to section 365(f)'s bar to enforcement of non-assignment provisions:

> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if —
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment.

11 U.S.C. § 365(c)(1).

The bankruptcy courts found that the trustee was barred from assigning the full golf memberships by Ohio law under § 365(c). The courts concluded that the club's rules were, in effect, anti-assignment provisions, and that Ohio law excused the club from accepting performance by others. The court thus gave effect to the provisions. [The district court affirmed]

The trustee then appealed to this court. We conclude that the decision of the district court was correct for two reasons. First, as the district court found, the trustee had no power under § 365 of the Code to assign this executory contract. Second, the relationships created by the various contracts between the club and its members create a type of property interest held by the parties to those contracts, the sale of which as proposed by the trustee adversely impacts on the property interests of others such that the sale is prohibited by § 363(e) of the Code.

The trustee asserts that what is involved is simply an executory contract between the bankrupt and the club permitting the bankrupt to play golf on the club course. As such, the trustee asserts that this executory contract can be sold and assigned, and the estate of the bankrupt is entitled to the value that can be realized from such an assignment and sale.

In examining the trustee's right to assign through sale the full golf membership, we should make clear that we are not dealing with the right to assume the membership with all its baggage, thus permitting the debtor to play golf. What is involved here is the right of the trustee to sell and assign it to another person without consideration of the rights of others that encumber it. The court cannot envision a reason why the trustee would want to continue to pay dues and permit the debtor to enjoy the benefits of a full golf membership, but nothing in this case relates to that question. It is the claimed right to sell and assign which we address.

Several courts have addressed the scope of § 365(c), although the decisions are not persuasive. A seminal decision was *In re Taylor Manufacturing, Inc.*, 6 B.R. 370, 372 (Bankr. N.D. Ga. 1980). That court concluded that § 365(c) was intended "to be applied narrowly and to such circumstances as contracts for the performance of non-delegable duties."

Apparently because of an example used by the Taylor court involving an opera singer's contract, *Taylor* was often cited subsequently for the proposition that § 365(c) applied only to personal service contracts (a construction which, as the Taylor court noted, actually originated with Collier on Bankruptcy).

The Court of Appeals for the First Circuit attempted to harmonize sections 365(f) and (c) in the case of *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984). That court also held that

no personal service contract limitation appeared in the language of § 365(c). In attempting to reach a rational explanation of the interplay of sections 365(f) and (c), however, the court proceeded to read additional language into § 365(f):

> As a matter of logic ... we see no conflict, for (c)(1)(A) refers to state laws that prohibit assignment "whether or not" the contract is silent, while (f)(1) contains no such limitation. Apparently (f)(1) includes state laws that prohibit assignment only when the contract is not silent about assignment; that is to say, state laws that enforce contract provisions prohibiting assignment.

Id. at 29. There is simply nothing in the language of § 365(f) which supports the limitation read into it by that court. In addition, it is at least equally as plausible that the phrase "whether or not such contract ... prohibits ... assignment" in § 365(c) was intended merely to emphasize that § 365(c) should not be construed to apply only to applicable law barring assignment, irrespective of the contract's provisions (as opposed to applicable law enforcing anti-assignment provisions in certain contracts), a construction which might otherwise seem logical in light of § 365(f)'s explicit override of contractual anti-assignment provisions. Neither *Pioneer Ford* nor any other decision to date provides a defensible explication of the parameters of the § 365(c) exception.

We must read sections 365(f) and (c) together. At first, it might seem that they are not consistent, but a careful parsing of the provisions suggests that § 365(f) contains the broad rule and § 365(c) contains a carefully crafted exception to the broad rule made necessary by general principles of the common law and our constitutions.

The parameters of subsections (f) and (c) are revealed through a straightforward reading of those subsections. Subsection (f) states that although the contract or applicable law prohibits assignment, these provisions do not diminish the broad power to assume and assign executory contracts granted the trustee by § 365(a). In other words, a general prohibition against the assignment of executory contracts, i.e., by contract or "applicable law," is ineffective against the trustee. In this case the complex nature of the arrangements by the parties for filling vacancies in the full golf membership category is a clear statement that by virtue of these arrangements the parties may not assign these memberships. However, subsection (f), by specific reference to subsection (c), allows one specific circumstance in which the power of the trustee may be diminished. Subsection (c) states that if the attempted assignment by the trustee will impact upon the rights of a non-debtor third party, then any applicable law protecting the right of such party to refuse to accept from or render performance to an assignee will prohibit assignment by the trustee. While subsections (f) and (c) appear contradictory by referring to "applicable law" and commanding opposite results, a careful reading reveals that each subsection recognizes an "applicable law" of markedly different scope.

Thus, in application to this case, § 365(f) permits the executory contract between the plaintiffs and the club regarding full golf membership to be assigned by the trustee even though the arrangements between the club and its members clearly do not permit them to assign such contracts, unless there is something in § 365(c) that indicates to the contrary.

Section 365(c) requires us to look at the rights and duties of the club as the other party to the contract and the "applicable law" regarding whether the club must accept performance from the assignee member chosen by the trustee or render performance to that member. As required in

§ 365(c), the applicable law of controlling significance to the solution of this problem addresses the interests of the non-debtor third parties, rather than law relating to general prohibitions or restrictions on assignment of executory contracts covered by § 365(f).

This leads us to a careful examination of Ohio law in light of the nature of the contract. We must determine whether Ohio law excuses the club, as "a party other than the debtor," from accepting as a full golfing member a person chosen by the trustee to be that member.

Ohio law does not want the courts involved in the internal workings of associations when those associations have rationally developed rule and procedures.

The contracts creating the complex relationships among the parties and others are not in any way commercial. They create personal relationships among individuals who play golf, who are waiting to play golf, who eat together, swim and play together. They are personal contracts and Ohio law does not permit the assignment of personal contracts.

So-called personal contracts, or contracts in which the personality of one of the parties is material, are not assignable. Whether the personality of one or both parties is material depends on the intention of the parties, as shown by the language which they have used, and upon the nature of the contract.

The claim that the assignment will be made only to those who are already members of the club is not relevant. "Nor would the fact that a particular person it attempted to designate [assign] was personally unexceptionable affect the nature of the contract." Therefore, we believe that the trustee's motion to assign the full golf membership should be denied. We reach this conclusion because the arrangements for filling vacancies proscribe assignment, the club did not consent to the assignment and sale, and applicable law excuses the club from accepting performance from or rendering performance to a person other than the debtor.

A second reason exists for denial of the trustee's motion to assume and assign these full golf memberships. Section 363(e) of the Code directs that "use, sale, or lease" of property by the trustee may be "prohibited[ed] or condition[ed]" in light of interests held by others in the subject property. In this instance, auctioning the full golf membership, although couched in terms of assignment, is a sale of a property interest and cannot be reconciled with the rights of persons on the waiting list, the club itself, or other members of the club.

The trustee seeks to re-shape that for which the debtor bargained. When the debtor became a golfing member, he contracted for the right to play golf subject to the rights and privileges of those on the waiting list. The trustee wishes to assume and sell not the limited bundle of rights and duties purchased by the debtor but a much larger bundle of rights, including the rights of the persons on the waiting list — the right to be next in line — and without a redetermination of the economic value of each membership. If allowed, a new contract would be written, creating new and different property rights.

Section 363(e) of the Code directs that when property is to be sold by the trustee, notwithstanding other provisions of § 363, the court shall prohibit or make conditions necessary to protect other persons having an interest in the property to be sold. Since the trustee is attempting not only to sell the debtor's right to play golf but also the rights of those on the waiting list to fill the next vacancy, the court was correct in denying the trustee's motion. The interest of the persons

presently involved in this orderly succession cannot adequately be protected in any manner except by prohibiting the sale and assignment of the membership.

In accordance with our conclusions set forth above, the denial of the trustee's motion to assign the full golf membership is

AFFIRMED.

RALPH B. GUY, JR., Circuit Judge, concurring in result.

Although I agree with the result reached by the court, I arrive at the result by different reasoning. . . . I turn instead to the longstanding Ohio rule which excuses a contracting party from rendering performance to, or accepting performance from, a third person or entity where the identity of the original contacting party was material. Such contracts are considered non-assignable precisely because of this right of refusal. In my view, this recognition of the right to refuse is the very sort of "applicable law" saved by section 365(c). And, in compliance with section 365(f), I do not rest my analysis on the fact that Ohio law makes such contracts non-assignable, but rather on the reason behind that legal conclusion.

Ohio courts have long recognized that

> [s]o-called personal contracts, or contracts in which the personality of one of the parties is material, are not assignable. Whether the personality of one or both parties is material depends upon the intention of the parties, as shown by the language which they have used, and upon the nature of the contract.

Given that the club is a voluntary association, the identity of its members is surely "material" to the membership agreements. The club's objection to the proposed assignment is the resulting interference with its ability to confer the full golf privileges on those members by the method of its choice. It makes no difference that the proposed offerees of Mr. Magness's full golf membership have already joined the association, or would be required to do so under the club's traditional procedures. "[T]he nature of the contract" is not affected by "the fact that the particular person [whom the would-be assignor] attempted to designate was personally unexceptionable." *Id*.

7.13. What is the Effect of Assumption or Rejection of Executory Contracts?

7.13.1. MISSION PRODUCT HOLDINGS, INC., v. TEMPNOLOGY, LLC, 139 S.Ct. 1652 (2019)

Section 365 of the Bankruptcy Code enables a debtor to "reject any executory contract"—meaning a contract that neither party has finished performing. 11 U.S.C. § 365(a). The section further provides that a debtor's rejection of a contract under that authority "constitutes a breach of such contract." § 365(g).

Today we consider the meaning of those provisions in the context of a trademark licensing agreement. The question is whether the debtor-licensor's rejection of that contract deprives the

licensee of its rights to use the trademark. We hold it does not. A rejection breaches a contract but does not rescind it. And that means all the rights that would ordinarily survive a contract breach, including those conveyed here, remain in place.

This case arises from a licensing agreement gone wrong. Respondent Tempnology, LLC, manufactured clothing and accessories designed to stay cool when used in exercise. It marketed those products under the brand name "Coolcore," using trademarks (e.g., logos and labels) to distinguish the gear from other athletic apparel. In 2012, Tempnology entered into a contract with petitioner Mission. The agreement gave Mission an exclusive license to distribute certain Coolcore products in the United States. And more important here, it granted Mission a non-exclusive license to use the Coolcore trademarks, both in the United States and around the world. The agreement was set to expire in July 2016. But in September 2015, Tempnology filed a petition for Chapter 11 bankruptcy. And it soon afterward asked the Bankruptcy Court to allow it to "reject" the licensing agreement. § 365(a).

Section 365(a) of the Code provides that a "trustee [or debtor], subject to the court's approval, may assume or reject any executory contract." § 365(a). A contract is executory if "performance remains due to some extent on both sides." Such an agreement represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform). Section 365(a) enables the debtor (or its trustee), upon entering bankruptcy, to decide whether the contract is a good deal for the estate going forward. If so, the debtor will want to assume the contract, fulfilling its obligations while benefiting from the counterparty's performance. But if not, the debtor will want to reject the contract, repudiating any further performance of its duties. The bankruptcy court will generally approve that choice, under the deferential "business judgment" rule.

According to Section 365(g), "the rejection of an executory contract[] constitutes a breach of such contract." As both parties here agree, the counterparty thus has a claim against the estate for damages resulting from the debtor's nonperformance. But such a claim is unlikely to ever be paid in full. That is because the debtor's breach is deemed to occur "immediately before the date of the filing of the [bankruptcy] petition," rather than on the actual post-petition rejection date. § 365(g)(1). By thus giving the counterparty a pre-petition claim, Section 365(g) places that party in the same boat as the debtor's unsecured creditors, who in a typical bankruptcy may receive only cents on the dollar.

In this case, the Bankruptcy Court (per usual) approved Tempnology's proposed rejection of its executory licensing agreement with Mission. That meant, as laid out above, two things on which the parties agree. First, Tempnology could stop performing under the contract. And second, Mission could assert (for whatever it might be worth) a pre-petition claim in the bankruptcy proceeding for damages resulting from Tempnology's nonperformance.

But Tempnology thought still another consequence ensued, and it returned to the Bankruptcy Court for a declaratory judgment confirming its view. According to Tempnology, its rejection of the contract also terminated the rights it had granted Mission to use the Coolcore trademarks. Tempnology based its argument on a negative inference. Several provisions in Section 365 state that a counterparty to specific kinds of agreements may keep exercising contractual rights after a debtor's rejection. For example, Section 365(h) provides that if a bankrupt landlord rejects a lease, the tenant need not move out; instead, she may stay and pay rent (just as she did before)

until the lease term expires. And still closer to home, Section 365(n) sets out a similar rule for some types of intellectual property licenses: If the debtor-licensor rejects the agreement, the licensee can continue to use the property (typically, a patent), so long as it makes whatever payments the contract demands. But Tempnology pointed out that neither Section 365(n) nor any similar provision covers trademark licenses. So, it reasoned, in that sort of contract a different rule must apply: The debtor's rejection must extinguish the rights that the agreement had conferred on the trademark licensee. The Bankruptcy Court agreed. It held, relying on the same "negative inference," that Tempnology's rejection of the licensing agreement revoked Mission's right to use the Coolcore marks.

The Bankruptcy Appellate Panel reversed, relying heavily on a decision of the Court of Appeals for the Seventh Circuit about the effects of rejection on trademark licensing agreements. Rather than reason backward from Section 365(n) or similar provisions, the Panel focused on Section 365(g)'s statement that rejection of a contract "constitutes a breach." Outside bankruptcy, the court explained, the breach of an agreement does not eliminate rights the contract had already conferred on the non-breaching party. So neither could a rejection of an agreement in bankruptcy have that effect. A rejection "convert[s]" a "debtor's unfulfilled obligations" to a pre-petition damages claim. But it does not "terminate the contract" or "vaporize[]" the counterparty's rights. Mission could thus continue to use the Coolcore trademarks.

But the Court of Appeals for the First Circuit rejected the Panel's and Seventh Circuit's view, and reinstated the Bankruptcy Court decision terminating Mission's license. The majority first endorsed that court's inference from Section 365(n) and similar provisions. It next reasoned that special features of trademark law counsel against allowing a licensee to retain rights to a mark after the licensing agreement's rejection. Under that body of law, the majority stated, the trademark owner's "[f]ailure to monitor and exercise [quality] control" over goods associated with a trademark "jeopardiz[es] the continued validity of [its] own trademark rights." So if (the majority continued) a licensee can keep using a mark after an agreement's rejection, the licensor will need to carry on its monitoring activities. And according to the majority, that would frustrate "Congress's principal aim in providing for rejection": to "release the debtor's estate from burdensome obligations." Ibid. (internal quotation marks omitted). Judge Torruella dissented, mainly for the Seventh Circuit's reasons.

What is the effect of a debtor's (or trustee's) rejection of a contract under Section 365 of the Bankruptcy Code? The parties and courts of appeals have offered us two starkly different answers. According to one view, a rejection has the same consequence as a contract breach outside bankruptcy: It gives the counterparty a claim for damages, while leaving intact the rights the counterparty has received under the contract. According to the other view, a rejection (except in a few spheres) has more the effect of a contract rescission in the non-bankruptcy world: Though also allowing a damages claim, the rejection terminates the whole agreement along with all rights it conferred. Today, we hold that both Section 365's text and fundamental principles of bankruptcy law command the first, rejection-as-breach approach. We reject the competing claim that by specifically enabling the counterparties in some contracts to retain rights after rejection, Congress showed that it wanted the counterparties in all other contracts to lose their rights. And we reject an argument for the rescission approach turning on the distinctive features of trademark licenses. Rejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach.

We start with the text of the Code's principal provisions on rejection— and find that it does much of the work. As noted earlier, Section 365(a) gives a debtor the option, subject to court approval, to "assume or reject any executory contract." And Section 365(g) describes what rejection means. Rejection "constitutes a breach of [an executory] contract," deemed to occur "immediately before the date of the filing of the petition." Or said more pithily for current purposes, a rejection is a breach. And "breach" is neither a defined nor a specialized bankruptcy term. It means in the Code what it means in contract law outside bankruptcy. So the first place to go in divining the effects of rejection is to non-bankruptcy contract law, which can tell us the effects of breach.

Consider a made-up executory contract to see how the law of breach works outside bankruptcy. A dealer leases a photocopier to a law firm, while agreeing to service it every month; in exchange, the firm commits to pay a monthly fee. During the lease term, the dealer decides to stop servicing the machine, thus breaching the agreement in a material way. The law firm now has a choice (assuming no special contract term or state law). The firm can keep up its side of the bargain, continuing to pay for use of the copier, while suing the dealer for damages from the service breach. Or the firm can call the whole deal off, halting its own payments and returning the copier, while suing for any damages incurred. But to repeat: The choice to terminate the agreement and send back the copier is for the law firm. By contrast, the dealer has no ability, based on its own breach, to terminate the agreement. Or otherwise said, the dealer cannot get back the copier just by refusing to show up for a service appointment. The contract gave the law firm continuing rights in the copier, which the dealer cannot unilaterally revoke.

And now to return to bankruptcy: If the rejection of the photocopier contract "constitutes a breach," as the Code says, then the same results should follow (save for one twist as to timing). Assume here that the dealer files a Chapter 11 petition and decides to reject its agreement with the law firm. That means, as above, that the dealer will stop servicing the copier. It means, too, that the law firm has an option about how to respond—continue the contract or walk away, while suing for whatever damages go with its choice. (Here is where the twist comes in: Because the rejection is deemed to occur "immediately before" bankruptcy, the firm's damages suit is treated as a pre-petition claim on the estate, which will likely receive only cents on the dollar. And most important, it means that assuming the law firm wants to keep using the copier, the dealer cannot take it back. A rejection does not terminate the contract. When it occurs, the debtor and counterparty do not go back to their pre-contract positions. Instead, the counterparty retains the rights it has received under the agreement. As after a breach, so too after a rejection, those rights survive.

All of this, it will hardly surprise you to learn, is not just about photocopier leases. Sections 365(a) and (g) speak broadly, to "any executory contract[s]." Many licensing agreements involving trademarks or other property are of that kind (including, all agree, the Tempnology-Mission contract). The licensor not only grants a license, but provides associated goods or services during its term; the licensee pays continuing royalties or fees. If the licensor breaches the agreement outside bankruptcy (again, barring any special contract term or state law), everything said above goes. In particular, the breach does not revoke the license or stop the licensee from doing what it allows. And because rejection "constitutes a breach," § 365(g), the same consequences follow in bankruptcy. The debtor can stop performing its remaining obligations under the agreement. But the debtor cannot rescind the license already conveyed. So the licensee can continue to do whatever the license authorizes.

In preserving those rights, Section 365 reflects a general bankruptcy rule: The estate cannot possess anything more than the debtor itself did outside bankruptcy. As one bankruptcy scholar has put the point: Whatever "limitation[s] on the debtor's property [apply] outside of bankruptcy[] appl[y] inside of bankruptcy as well. A debtor's property does not shrink by happenstance of bankruptcy, but it does not expand, either." D. Baird, Elements of Bankruptcy 97 (6th ed. 2014). So if the not-yet debtor was subject to a counterparty's contractual right (say, to retain a copier or use a trademark), so too is the trustee or debtor once the bankruptcy petition has been filed. The rejection-as-breach rule (but not the rejection-as-rescission rule) ensures that result. By insisting that the same counterparty rights survive rejection as survive breach, the rule prevents a debtor in bankruptcy from recapturing interests it had given up.

And conversely, the rejection-as-rescission approach would circumvent the Code's stringent limits on "avoidance" actions—the exceptional cases in which trustees (or debtors) may indeed unwind pre-bankruptcy transfers that undermine the bankruptcy process. The most notable example is for fraudulent conveyances— usually, something-for-nothing transfers that deplete the estate (and so cheat creditors) on the eve of bankruptcy. See § 548(a). A trustee's avoidance powers are laid out in a discrete set of sections in the Code, see §§ 544-553, far away from Section 365. And they can be invoked in only narrow circumstances—unlike the power of rejection, which may be exercised for any plausible economic reason. See, e.g., § 548(a) (describing the requirements for avoiding fraudulent transfers). If trustees (or debtors) could use rejection to rescind previously granted interests, then rejection would become functionally equivalent to avoidance. Both, that is, would roll back a prior transfer. And that result would subvert everything the Code does to keep avoidances cabined—so they do not threaten the rule that the estate can take only what the debtor possessed before filing. Again, then, core tenets of bankruptcy law push in the same direction as Section 365's text: Rejection is breach, and has only its consequences.

Tempnology's main argument to the contrary, here as in the courts below, rests on a negative inference. Several provisions of Section 365, Tempnology notes, "identif[y] categories of contracts under which a counterparty" may retain specified contract rights "notwithstanding rejection." Sections 365(h) and (i) make clear that certain purchasers and lessees of real property and timeshare interests can continue to exercise rights after a debtor has rejected the lease or sales contract. See § 365(h)(1) (real-property leases); § 365(i) (real-property sales contracts); §§ 365(h)(2), (i) (timeshare interests). And Section 365(n) similarly provides that licensees of some intellectual property—but not trademarks—retain contractual rights after rejection. See § 365(n); § 101(35A). Tempnology argues from those provisions that the ordinary consequence of rejection must be something different—i.e., the termination, rather than survival, of contractual rights previously granted. Otherwise, Tempnology concludes, the statute's "general rule" would "swallow the exceptions."

But that argument pays too little heed to the main provisions governing rejection and too much to subsidiary ones. On the one hand, it offers no account of how to read Section 365(g) (recall, rejection "constitutes a breach") to say essentially its opposite (i.e., that rejection and breach have divergent consequences). On the other hand, it treats as a neat, reticulated scheme of "narrowly tailored exception[s]," what history reveals to be anything but. Each of the provisions Tempnology highlights emerged at a different time, over a span of half a century. And each responded to a discrete problem—as often as not, correcting a judicial ruling of just the kind Tempnology urges. See Andrew, Executory Contracts in Bankruptcy, 59 U. Colo. L. Rev. 845,

911-912 (1988) (identifying judicial decisions that the provisions overturned). Read as generously as possible to Tempnology, this mash-up of legislative interventions says nothing much of anything about the content of Section 365(g)'s general rule. Read less generously, it affirmatively refutes Tempnology's rendition. As one bankruptcy scholar noted after an exhaustive review of the history: "What the legislative record [reflects] is that whenever Congress has been confronted with the consequences of the [view that rejection terminates all contractual rights], it has expressed its disapproval." Andrew, 59 U. Colo. L. Rev., at 928. On that account, Congress enacted the provisions, as and when needed, to reinforce or clarify the general rule that contractual rights survive rejection.

Consider more closely, for example, Congress's enactment of Section 365(n), which addresses certain intellectual property licensing agreements. No one disputes how that provision came about. In *Lubrizol Enterprises v. Richmond Metal Finishers*, the Fourth Circuit held that a debtor's rejection of an executory contract worked to revoke its grant of a patent license. In other words, Lubrizol adopted the same rule for patent licenses that the First Circuit announced for trademark licenses here. Congress sprang into action, drafting Section 365(n) to reverse *Lubrizol* and ensure the continuation of patent (and some other intellectual property) licensees' rights. As Tempnology highlights, that provision does not cover trademark licensing agreements, which continue to fall, along with most other contracts, within Section 365(g)'s general rule. But what of that? Even put aside the claim that Section 365(n) is part of a pattern—that Congress whacked Tempnology's view of rejection wherever it raised its head. Still, Congress's repudiation of *Lubrizol* for patent contracts does not show any intent to ratify that decision's approach for almost all others. Which is to say that no negative inference arises. Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g)—that rejection and breach have the same results.

Tempnology's remaining argument turns on the way special features of trademark law may affect the fulfillment of the Code's goals. Like the First Circuit below, Tempnology here focuses on a trademark licensor's duty to monitor and "exercise quality control over the goods and services sold" under a license. Absent those efforts to keep up quality, the mark will naturally decline in value and may eventually become altogether invalid. So (Tempnology argues) unless rejection of a trademark licensing agreement terminates the licensee's rights to use the mark, the debtor will have to choose between expending scarce resources on quality control and risking the loss of a valuable asset. "Either choice," Tempnology concludes, "would impede a [debtor's] ability to reorganize," thus "undermining a fundamental purpose of the Code."

To begin with, that argument is a mismatch with Tempnology's reading of Section 365. The argument is trademark-specific. But Tempnology's reading of Section 365 is not. Remember, Tempnology construes that section to mean that a debtor's rejection of a contract terminates the counterparty's rights "unless the contract falls within an express statutory exception." That construction treats trademark agreements identically to most other contracts; the only agreements getting different treatment are those falling within the discrete provisions just discussed. And indeed, Tempnology could not have discovered, however hard it looked, any trademark-specific rule in Section 365. That section's special provisions, as all agree, do not mention trademarks; and the general provisions speak, well, generally. So Tempnology is essentially arguing that distinctive features of trademarks should persuade us to adopt a construction of Section 365 that will govern

not just trademark agreements, but pretty nearly every executory contract. However serious Tempnology's trademark-related concerns, that would allow the tail to wag the Doberman.

And even putting aside that incongruity, Tempnology's plea to facilitate trademark licensors' reorganizations cannot overcome what Sections 365(a) and (g) direct. The Code of course aims to make reorganizations possible. But it does not permit anything and everything that might advance that goal. Here, Section 365 provides a debtor like Tempnology with a powerful tool: Through rejection, the debtor can escape all of its future contract obligations, without having to pay much of anything in return. But in allowing rejection of those contractual duties, Section 365 does not grant the debtor an exemption from all the burdens that generally applicable law—whether involving contracts or trademarks—imposes on property owners. Nor does Section 365 relieve the debtor of the need, against the backdrop of that law, to make economic decisions about preserving the estate's value—such as whether to invest the resources needed to maintain a trademark. In thus delineating the burdens that a debtor may and may not escape, Congress also weighed (among other things) the legitimate interests and expectations of the debtor's counterparties. The resulting balance may indeed impede some reorganizations, of trademark licensors and others. But that is only to say that Section 365's edict that rejection is breach expresses a more complex set of aims than Tempnology acknowledges.

For the reasons stated above, we hold that under Section 365, a debtor's rejection of an executory contract in bankruptcy has the same effect as a breach outside bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor's rejection cannot revoke the trademark license.

7.13.2. IN RE GARDINIER, INC., 831 F.2d 974 (11th Cir. 1987)

The issue in this bankruptcy case is whether an agreement to pay a brokerage commission, contained within the same document as a purchase and sale agreement, is a separate and distinct contract from the purchase and sale agreement.

Before filing its [bankruptcy] petition, Gardinier had agreed to sell a parcel of land known as the Goldstein tract to Boyd Burley [for] $5,117,000. In paragraph eight of the contract, Gardinier agreed to pay the broker, Kilgore Real Estate, a 10% commission for its "services in making sale of said property ... at the time of closing this transaction."

On March 22, 1985, pursuant to sections 363(b) and 365 of the Bankruptcy Code, Gardinier filed a motion with the bankruptcy court for entry of orders approving the assumption of the real estate contract and approving the sale of the Goldstein tract. The Unsecured Creditors Committee (the "Committee") raised an objection to the payment of Kilgore's brokerage commission on the ground that the brokerage agreement, although contained within the same instrument as the contract for the sale of the Goldstein tract, was a distinct, separate and fully executed agreement that could not be assumed post-petition.

The bankruptcy court denied payment of the broker's commission out of the sales proceeds, but acknowledged Kilgore's right to file a proof of claim for its unsecured, non-priority, pre-petition claim to the commission.

We agree with the bankruptcy court that the brokerage agreement was separate from the purchase and sale agreement. [T]he intention of the parties is the governing principle in contract construction, and, absent ambiguity in the terms of a contract, intent is gleaned from the four corners of the instrument. Furthermore, that the terms of a transaction are set forth in one instrument is not conclusive evidence that the parties intended to make only one contract, but is only a factor in determining intent. Thus, we look to the terms of the "Contract for Sale of Real Estate" to determine whether Gardinier, Burley, and Kilgore intended to make one contract or two separate contracts.

Although there is only one document memorializing this transaction, there is otherwise no clear indication from the face of the instrument that the parties intended to make only one contract. Instead, the terms of the instrument demonstrate that the parties intended to make two separate contracts. In its order, the bankruptcy court noted three aspects of the transaction that we agree are persuasive evidence of this intent. First, the nature and purpose of the agreements are different. One agreement addresses the sale of property and the other contemplates an employment contract related to the sale of the property. Second, the consideration for each agreement is separate and distinct. Burley agreed to pay Gardinier in excess of $5 million in consideration for the Goldstein tract. Gardinier separately agreed to pay Kilgore a commission as consideration for services rendered in making the sale of the property. There was no consideration flowing between the broker and the buyer. Finally, the obligations of each party to the instrument are not interrelated. Gardinier obligated itself to deliver the deed to Burley upon payment of the purchase price, and it obligated itself to pay a commission to Kilgore upon completion of the broker's responsibilities. There are no promises running between the broker and the purchaser; their only relation is that each has separate contractual rights with the seller.

The issue in other cases cited by the parties was whether numerous promises, each between the same promisor and promisee and contained within one instrument, constituted one or more contracts, and not, as here, whether two promises, each with a different promisor and promisee, constitute one or more contracts. Neither of the courts below nor either party cites any case suggesting that if promises between different parties are dependent or conditioned on one another, it is evidence that the parties intended the agreements to actually form one contract. Moreover, none offers any convincing reason why this should be so. Contracts are often conditioned upon the completion of totally separate agreements. Since the appellee fails to convince us that the independence or interdependence of the agreements is persuasive evidence of intent in this case, the only indication we have that the parties intended one contract is that the agreements appear in a single document. This by itself is insufficient to overcome the evidence discussed supra that demonstrates the parties' intent to form two contracts. Because Kilgore has not demonstrated that its agreement with Gardinier entitles it to special treatment, it must suffer the consequences of Gardinier's bankruptcy along with the other general creditors.

7.14. Can Contracts that are Not Assignable Under State Law Be Assigned in Bankruptcy?

7.14.1. IN RE JAMESWAY CORPORATION, 201 B.R. 73 (Bankr. S.D.N.Y. 1996)

On October 18, 1995 ("petition date"), [debtor] Jamesway filed petitions for relief under Chapter 11. At that time, debtors operated discount department stores under the "Jamesway" name. As of the petition date, Jamesway and Mass Mutual were parties to the "Newberry Lease," whereby Jamesway, as tenant, leased certain retail space located in the Newberry Commons shopping center in Etters, Pennsylvania. Paragraph 17 of that lease states in relevant part that:

> [I]f Tenant assigns this Lease or sublets all or substantially all of the demised premises . . . and such assignment or subletting commences in or extends into the extension periods reserved under Article 3 of this Lease, then during the first twenty (20) years of such extension periods . . . Tenant shall pay Landlord 50% of the "profits" received by Tenant from the assignee or sublessee. Thereafter, Tenant shall pay Landlord 60% of such profits. As used herein, "profits" shall mean the amount, if any, paid by the assignee or sublessee to Tenant in excess of the fixed rent and additional rent payable by Tenant for the corresponding period of such assignment or sublease, excluding the reasonable costs to Tenant for effectuating such assignment or sublease

Newberry Lease ¶ 17. On or about February 9, 1996, Jamesway moved under § 365 of the Bankruptcy Code to assume and assign the Newberry Lease to Rite Aid for $100,000 (the "Rite Aid Motion"). Over Mass Mutual's objection, we granted the motion. [A] dispute [then arose as to who is entitled to the premium paid by Rite Aid].

Jamesway contends that the subject lease provisions are void and unenforceable under § 365(f)(1) because they limit its ability to realize the full economic value of the Leases for the benefit of all unsecured creditors. Mass Mutual argues that § 365(f)(1) does not empower us to nullify the profit sharing provisions in the lease, but merely permits us to authorize the assignment over its objection. It argues that our power to invalidate lease provisions is limited by § 365(f)(3) to "ipso facto" or forfeiture provisions and that to hold otherwise will read § 365(f)(3) out of the statute.

Courts do not have carte blanche to rewrite leases under §§ 365(f)(1) and (f)(3) or any provision of the statute. However, § 365 reflects the clear Congressional policy of assisting the debtor to realize the equity in all of its assets. Toward that end, § 365(f)(1) permits assignment of an unexpired lease despite a clause in the lease prohibiting, conditioning or restricting the assignment. Subsection (f)(3) goes beyond the scope of subsection (f)(1) by prohibiting enforcement of any clause creating a right to modify or terminate the contract because it is being assumed or assigned, "thereby indirectly barring an assignment by the debtor." "The essence of Subsections (1) and (3) is that all contractual provisions, not merely those entitled `anti-assignment clauses' are subject to the court's scrutiny regarding their anti-assignment effect." While they

operate in tandem to promote the Congressional policy favoring a debtor's ability to maximize the value of its leasehold assets, subsections (f)(1) and (f)(3) deal with different problems; (f)(1) with provisions that prohibit, restrict or condition assignment, and (f)(3) with provisions that terminate or modify the terms of a lease because it has been assumed or assigned. For this reason, construing the former to invalidate provisions that directly or indirectly restrict the debtor's ability to assign the subject lease does not render § 365(f)(3) superfluous.

[W]e interpret § 365(f)(1) to invalidate provisions restricting, conditioning or prohibiting debtor's right to assign the subject lease. [L]ease provisions conditioning a debtor-in-possession's right to assignment upon the payment of some portion of the "profit" realized upon such assignment are routinely invalidated under § 365(f)(1).

The Landlords cannot, by artful drafting, thwart the fundamental bankruptcy policy allowing a debtor to realize maximum value from its assigned leases for the benefit of its estate and creditors. We grant debtor's request for an order declaring that the profit sharing provisions of the Leases are unenforceable and direct that the $50,000 currently held in escrow from the assignment proceeds of the Newberry Lease be released to debtor.

7.15. The Obligation to Perform Executory Contracts

7.15.1. IN RE COMPUTER COMMUNICATIONS, INC., 824 F.2d 725 (9th Cir. 1987)

Codex Corporation (Codex) unilaterally terminated its contract to purchase computer equipment from CCI after CCI filed a petition for reorganization under Chapter 11. The heart of the Agreement provided that Codex would make minimum quarterly purchases of equipment and software from CCI for incorporation in Codex's products. The parties executed an Amended Agreement on November 4, 1980 for a term of four years commencing April 1979. The value of the purchases under the Agreement aggregated $12.5 million. CCI agreed to provide technical support, training, and to make spare parts available. Finally, the Agreement stipulated that certain events, including bankruptcy, constituted default; established termination procedures; and stated that Massachusetts law governed the Agreement.

On November 6, 1980, two days after the parties executed the Amended Agreement, CCI filed a petition under Chapter 11 of the Bankruptcy Code. On December 30, 1980, Codex notified CCI that it was terminating the Agreement pursuant to ¶ 4.6.4 which provides:

In the event of the appointment of a trustee, receiver or liquidator for all or a major portion of the property of either party, the commission by either party of any act of bankruptcy as defined in the United States Bankruptcy Act, as amended, the filing by either party of any voluntary petition in bankruptcy, ... that party shall be in default upon actual notice to the other party of such event, and the other party may terminate this Agreement as provided in paragraph 4.6.2 or 4.6.3, as the case may be.

Codex failed to make its minimum purchase for the quarter ending December 31, 1980, and has failed to make its quarterly minimum purchase every quarter since.

CCI filed suit in bankruptcy court on January 30, 1981 for injunctive relief and damages asserting that Codex had wrongfully repudiated the contract and had violated the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 362.

On February 23, 1981, Codex notified CCI that it was terminating purchases of equipment from CCI pursuant to ¶ 4.6.1 of the Agreement. This clause [allows Codex to terminate its obligation to make future purchases by giving notice of termination].

The bankruptcy court . . . held that 11 U.S.C. § 365(e)(1) made the bankruptcy default clause unenforceable, the automatic stay of 11 U.S.C. § 362 prohibited Codex from unilaterally terminating the Agreement under either ¶ 4.6.1 or ¶ 4.6.4, Codex should have applied to the court for relief from the automatic stay, and Codex willfully violated the automatic stay. The court awarded general damages of $4,750,000 plus $250,000 in punitive damages.

Codex appealed to the district court [and the] district court affirmed the general damage award and reversed the punitive damage award.

11 U.S.C. § 362 provides that the filing of a bankruptcy petition automatically stays "any act to obtain possession of property of the estate...." 11 U.S.C. § 362(a)(3). The courts below held that the automatic stay prohibited Codex from unilaterally terminating the Agreement. We agree. Even if Codex had a valid reason for terminating the Agreement, it still was required to petition the court for relief from the automatic stay under § 362(d).

11 U.S.C. § 541 (1982) defines property of the estate. It neither explicitly includes nor excludes contract rights. The definition includes "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The legislative history states that the scope for this paragraph is broad. "It includes all kinds of property, including tangible or intangible property [and] causes of action...." H.R.Rep. No. 595 at 367, reprinted in 1978 U.S.Code Cong. & Admin.News at 6323.

The automatic stay does not permanently prohibit a party from retrieving property from the possession of the bankrupt estate. Section 362(d) provides [for the bankruptcy court to grant relief from stay in certain circumstances upon request].

Codex argues that the trial court erred because the contract was not property of the estate. It asserts that 11 U.S.C. § 365 (1982), pertaining to executory contracts and unexpired leases, sanctioned its termination of the contract. Section 365 provides that a trustee may assume or reject any executory contract or unexpired lease of the debtor. The contract, argues Codex, never became property of the estate because the trustee did not and could not assume it. Section 365(e) generally prohibits exercise of bankruptcy termination clauses in such contracts:

Subparagraph (2), however, creates an exception where "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease...." 11 U.S.C. § 365(e)(2)(A)(i). Codex argues that Massachusetts law excused it from accepting performance from an assignee for three reasons: 1) the Agreement was a personal service contract; 2) even if it was not a personal service contract, it was a contract based on "a relation of personal confidence," and 3) assignment of the contract would have revealed Codex's trade secrets.

The bankruptcy court held that § 365(e)(2) did not permit Codex to terminate the contract unilaterally finding that the Amended Agreement was not a contract for personal services.

Likewise, the district court concluded that the contract was almost entirely for the sale of goods. We need not reach that question, however, because we hold that even if § 365(e)(2) allowed Codex to terminate the contract, § 362 automatically stayed termination.

Codex argues that, since executory contracts do not automatically vest in the bankrupt estate, but must be assumed by the executor, they are not automatically stayed. We find this argument unavailing. . . . We agree with the analysis of the bankruptcy court in *In re Wegner Farms Co.*, 49 B.R. 440 (Bankr. N.D. Iowa 1985), which held that even if, under section 365(e), a bonding agreement cannot be assumed by the debtor, it must be terminated pursuant to the terms of the automatic stay provision.

The legislative history emphasizes that the stay is intended to be broad in scope. Congress designed it to protect debtors and creditors from piecemeal dismemberment of the debtor's estate. The automatic stay statute itself provides a summary procedure for obtaining relief from the stay. All parties benefit from the fair and orderly process contemplated by the automatic stay and judicial relief procedure. Judicial toleration of an alternative procedure of self-help and post hoc justification would defeat the purpose of the automatic stay. Accordingly, we affirm the bankruptcy and district courts on the ground that Codex violated the automatic stay by unilaterally terminating the contract and do not reach the question of whether this contract is non-assignable under Massachusetts law.

We hold that awarding damages to CCI for Codex's violation of the automatic stay was within the discretion of the bankruptcy court. We find the damage award reasonable.

AFFIRMED.

7.16. Practice Problems: Executory Contracts – Assumption and Rejection

Answer the following questions:

Problem 1. The Trustee wants to assume a prepetition contract of the Debtor to buy goods from Seller. If the Debtor was in default under the contract prepetition, what must the Trustee do and show in order to assume the contract? 11 U.S.C. § 365(b).

Problem 2. What must the Trustee do or show to provide "adequate assurance of future performance? *See* 11 U.S.C. § 365(b)(3), and note that this provision only applies to shopping center leases.

Problem 3. Assume that the contract in Problem (1) provides as follows: "Seller has the right to terminate the contract without prior notice if the debtor is insolvent, files bankruptcy, or if a trustee or receiver is appointed over the debtor's property." How could the Trustee possibly cure this default? *See* 11 U.S.C. §§ 365(b)(2); 365(e)(1).

Problem 4. Shortly before filing bankruptcy, Debtor obtained a $1 million line of credit from Banko Americo, which can be drawn on at any time within the next three years. Debtor has only drawn $100,000 on the line, leaving $900,000 available. The Trustee would like to use some of that money to pay the expenses of administration. May the Trustee assume the loan and draw down on the credit line? 11 U.S.C. § 365(c)(2).

Problem 5. How long does a Chapter 7 trustee have to decide whether to assume or reject an executory contract or unexpired lease? 11 U.S.C. § 365(d)(1). How long would a Chapter 11 trustee have? In answering this question, does the type of property covered by the agreement matter? What is the consequence of not acting timely? 11 U.S.C. § 365(d).

Problem 6. Does the Trustee have to perform the Debtor's obligations under an executory contract or lease while deciding whether to assume or reject? *See* 11 U.S.C. § 365(d)(3) and (d)(5).

Problem 7. Assume that the Trustee rejects an executory contract, and that the other party to the contract would have a $1 million claim for damages under state law if the debtor had breached the contract pre-petition. Is the counter-party's claim against the estate after rejection entitled to priority as a post-petition expense of administration? 11 U.S.C. § 365(g)(1). What if the Trustee assumed the contract and later was unable to perform?

Problem 8. Debtor owns a shopping center. Tenant has 75 years left on its 100 year lease on the best location in the center, and is paying a fraction of the fair rental value of the store. Debtor has heard about the rejection of executory contracts and leases in bankruptcy. Debtor would like to kick the Tenant out of the premises and re-lease the space for a much higher rent. Debtor proposes to file bankruptcy, reject the lease, kick Tenant out, and rent to a new tenant for a much higher rent. What do you think of this strategy? *See* 11 U.S.C. § 365(h)(1)(A).

Problem 9. Assume that Tenant in Problem (8), rather than Landlord, files bankruptcy after falling behind on its rent. The tenancy has a lot of value, and the Trustee wants to assign the below market lease to another company who will pay a much higher rent to the Trustee than the rate under the lease. The lease prohibits Tenant from assigning the lease, and that restriction is enforceable outside of bankruptcy under applicable state law. Can Tenant assign the lease in bankruptcy even though the lease prohibits assignment? 11 U.S.C. § 365(f)(2). If so, what must Trustee do or show to get the bankruptcy court to approve the assignment? 11 U.S.C. § 365(b)(1), (b)(3), (f).

Problem 10. What if, during the month before bankruptcy, a shopping center tenant stopped operating the store because its store sales were less than its operating costs? Under the lease, closing the store is an incurable default allowing Landlord to terminate the lease. Is there any way for the Trustee to cure this kind of default? *See* 11 U.S.C. § 365(b)(1)(A).

Problem 11. Assume that the Trustee in Problem (9) is successful in assigning the lease, and the Assignee later defaults. Is the Debtor's estate liable to the landlord for damages (and for an administrative claim for damages since the lease was assumed)? 11 U.S.C. § 365(k).

Problem 12. Prior to filing bankruptcy, the Debtor leased a fancy laptop computer from Dull Computers for a three year term. Trustee rejected the lease because the rental value of the laptop was much less than the lease payments. The Debtor wants to keep the computer. What can Debtor do? *See* 11 U.S.C. § 365(p). What if Dull unreasonably refuses to accept Debtor's very fair proposal to keep the laptop?

Problem 13. Multi-millionaire fashion designer Bruno agreed to pay $1 million to famous graffiti artist Blankley to paint Bruno's portrait on the side of a building. Because of unrelated financial problems, Blankley was forced to file Chapter 11 and seek to reorganize. When Blankley sought to assume the contract, Bruno, who no longer wanted his portrait to be painted by a "bankrupt" artist, objected. Bruno claimed that the contract cannot be assumed under Section 365

because it is an unassignable personal services contract under section 365(c)(1)(A). Blankley argues that he should be able to assume because he is the same person with whom the contract was made. Should the personal services prohibition in 365(c)(1)(A) only apply to an assumption by the trustee or assignment to a third party, or should it apply equally to an assumption by the debtor-in-possession? *Compare* *In re Footstar*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005) (adopting actual test) with *In re Catapult Entm't, Inc.,* 165 F.3d 747 (9th Cir. 1999) (adopting hypothetical test).

Problem 14. Actress Tia Carrere, who was under contract to perform in a soap opera, sought to use bankruptcy to reject her old soap opera contract and enable her to enter into a more lucrative contract to appear on a hot new television show called the "A Team." In another case, a franchisee sought to reject a franchise agreement while continuing to operate a similar business in the same location. In both cases, the contracts that the debtors sought to reject contained restrictive covenants preventing the debtors from competing. Does the rejection of a contract containing a restrictive covenant prevent the other contracting party from enforcing the restrictive covenant by way of injunction? *See* *In Re Carrere*, 64 B.R. 156 (Bankr. C.D. Cal. 1986) (personal services contract not property of the estate that could be assumed or rejected, and therefore restrictive covenant could be enforced); *Silk Plants, Etc. Franchise Systems v. Register*, 100 B.R. 360 (M.D. Tenn. 1989) (franchisor could not enforce the restrictive covenant after rejection). To some extent, the correct answer may turn on whether the right to an injunction under state law is a "claim" subject to the Bankruptcy Code's claim procedures. *See 11 U.S.C. § 101(5)(B);* *In re Ward,* 194 B.R. 703, 712 (Bankr. D. Mass. 1996).

Chapter 8. Enhancing the Estate

8.1. Standing to Assert Claims Belonging to Creditors

8.1.1. IN RE BERNARD L. MADOFF INVESTMENT SECURITIES LLC., 721 F. 3d 54 (2d Cir. 2013]

Irving Picard ("Picard" or the "Trustee") sues in his capacity as Trustee under the Securities Investor Protection Act ("SIPA") on behalf of victims in the multi-billion-dollar Ponzi scheme worked by Bernard Madoff. The four actions presently before this Court allege that numerous major financial institutions aided and abetted the fraud, collecting steep fees while ignoring blatant warning signs. In summary, the complaints allege that, when the Defendants were confronted with evidence of Madoff's illegitimate scheme, their banking fees gave incentive to look away, or at least caused a failure to perform due diligence that would have revealed the fraud. The Trustee asserts claims for unjust enrichment, breach of fiduciary duty, aiding and abetting fraud, and negligence, among others. The Trustee's position is supported by the Securities Investor Protection Corporation ("SIPC"), a statutorily created nonprofit corporation consisting of registered broker-dealers and members of national securities exchanges, which intervened to recover some or all of the approximately $800 million it advanced to victims.

As we will explain, the doctrine of *in pari delicto* bars the Trustee (who stands in Madoff's shoes) from asserting claims directly against the Defendants on behalf of the *estate* for wrongdoing in which Madoff (to say the least) participated. The claim for contribution is likewise unfounded, as SIPA provides no such right. The decisive issue, then, is whether the Trustee has standing to pursue the common law claims on behalf of Madoff's *customers*. Two thorough well-reasoned opinions by the district courts held that he does not.

Our holding relies on a rooted principle of standing: A party must "assert his own legal rights and interests, and cannot rest his claim to relief on the legal rights or interests of third parties." This prudential limitation has been consistently applied in the bankruptcy context to bar suits brought by trustees on behalf of creditors.

In December 2008, federal agents arrested Bernard L. Madoff, who had conducted the largest Ponzi scheme yet uncovered. Madoff purported to employ a "split-strike conversion strategy" that involved buying S & P 100 stocks and hedging through the use of options. In reality, he engaged in no securities transactions at all.

In March 2009, Madoff pleaded guilty to securities fraud and admitted that he had used his brokerage firm, Bernard L. Madoff Investment Securities LLC ("BLMIS"), as a vast Ponzi scheme.

Following Madoff's arrest, SIPC filed an application under SIPA, 15 U.S.C. § 78eee(a)(4)(B), asserting that BLMIS required protection. The district court appointed Picard as the firm's Trustee and referred the case to the bankruptcy court.

If (as is often the case) the assets are not enough to satisfy all net equity claims, SIPC advances money (up to $500,000 per customer) to the SIPA trustee, who is charged with assessing

customer claims and making the ratable distributions. At the time of this appeal, SIPC had advanced approximately $800 million.

A trustee also has authority to investigate the circumstances surrounding the insolvency and to recover and distribute any remaining funds to creditors. Picard alleges that his investigation has uncovered evidence of wrongdoing by third parties who aided and abetted Madoff, and seeks to replenish the fund of customer property by taking action against various financial institutions that serviced BLMIS.

Picard presses claims against JPMorgan Chase & Co., UBS AG, UniCredit Bank Austria AG, HSBC Bank plc, and affiliated persons and entities. [The opinion recites the specific allegations against each entity, showing that the defendants made large profits from Madoff business, while failing to segregate Madoff's customer assets and ignoring red flags about his unrealistic returns.]

On July 15, 2009, the Trustee commenced an adversary proceeding in the United States Bankruptcy Court for the Southern District of New York against HSBC and thirty-six others, including UniCredit and Pioneer. The Amended Complaint sought recovery of $2 billion in preferential or fraudulent transfers (Counts 1 through 19), and asserted four common law causes of action: aiding and abetting fraud, aiding and abetting breach of fiduciary duty, unjust enrichment, and money had and received (collectively, the "common law claims"). These common law claims sought $6.6 billion from HSBC and $2 billion from the remaining defendants.

[The lower courts dismissed the common law claims "on the grounds that the Trustee was *in pari delicto* with the defendants, lacked standing to assert the common law claims on customers' behalf."]

We agree with the district courts that the Trustee's common law claims asserted on behalf of BLMIS are barred by the doctrine of *in pari delicto*.

Under New York law, one wrongdoer may not recover against another. The principle that a wrongdoer should not profit from his own misconduct "is ... strong in New York." The New York Appellate Division, First Department, has long applied the doctrine of *in pari delicto* to bar a debtor from suing third parties for a fraud in which he participated.

A "claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." The debtor's misconduct is imputed to the trustee because, innocent as he may be, he acts as the debtor's representative. *See Wight v. BankAmerica Corp*., 219 F.3d 79, 87 (2d Cir.2000) ("[B]ecause a trustee stands in the shoes of the corporation, the Wagoner rule bars a trustee from suing to recover for a wrong that he himself essentially took part in."); *accord Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Grp., Inc.),* 336 F.3d 94, 99-100 (2d Cir.2003) (applying *Wagoner* rule in the context of "the greatest Ponzi scheme [then] on record" and holding that "the defrauded investors and not the bankruptcy trustee" were entitled to pursue malpractice claims against attorneys and accountants arising from the fraud).

Picard alleges that the Defendants were complicit in Madoff's fraud and facilitated his Ponzi scheme by providing (well-paid) financial services while ignoring obvious warning signs. These claims fall squarely within the rule of *Wagoner* and the ensuing cases: Picard stands in the

shoes of BLMIS and may not assert claims against third parties for participating in a fraud that BLMIS orchestrated.

Picard's scattershot responses are resourceful, but they all miss the mark. He contends that a SIPA trustee is exempt from the *Wagoner* rule, but adduces no authority. He argues that the rationale of the *in pari delicto doctrine* is not served here because he himself is not a wrongdoer; but neither were the trustees in the cases cited above. He invokes the "adverse interest" exception, which directs a court not to impute to a corporation the bad acts of its agent when the fraud was committed for personal benefit. However, "this most narrow of exceptions" is reserved for cases of "outright theft or looting or embezzlement ... where the fraud is committed against a corporation rather than on its behalf." It is not possible thus to separate BLMIS from Madoff himself and his scheme. Finally, Picard argues that the district courts should not have applied the *in pari delicto* doctrine at the pleadings stage; but the New York Court of Appeals has held otherwise. Early resolution is appropriate where (as here) the outcome is plain on the face of the pleadings.

The Trustee's claim for contribution is the only one that may escape the bar of in pari delicto. The Trustee seeks contribution for payments made to BLMIS customers under SIPA, on the theory that the Defendants are joint tortfeasors with BLMIS under New York law.

The New York statute provides that "two or more persons who are subject to liability for damages for the same personal injury, injury to property or wrongful death, may claim contribution among them whether or not an action has been brought or a judgment has been rendered against the person from whom contribution is sought." N.Y. C.P.L.R. § 1401 (McKinney). Section 1401 "requires some form of compulsion; that is, the party seeking contribution must have been compelled in some way, such as through the entry of a judgment, to make the payment against which contribution is sought."

However, the SIPA payments for which Picard seeks contribution were not compelled by BLMIS's state law fraud liability to its customers; his obligation to pay customers their ratable share of customer property is an obligation of federal law: SIPA. SIPA provides no right to contribution, and it is settled in this Circuit that there is no claim for contribution unless the operative federal statute provides one.

Picard emphasizes that he is not seeking contribution for violations of SIPA or any other federal statute, but that is beside the point. "The source of a right of contribution under state law must be an obligation imposed by state law." The issue is therefore whether the payments made by the Trustee, for which he is seeking contribution, are required by state or federal law—an easy question.

The $800 million paid out to customers fulfilled an obligation created by SIPA, a federal statute that does not provide a right to contribution "either expressly or by clear implication," Unlike the Bankruptcy Act, SIPA does not require customers to establish a basis of liability as a prerequisite for the Trustee's disbursement obligation. The loss itself is enough. Because the Trustee's payment obligations were imposed by a federal law that does not provide a right to contribution, the district courts properly dismissed these claims.

Having rejected the Trustee's claims asserted on behalf of BLMIS, we consider next whether the Trustee may assert such claims on behalf of BLMIS's customers. To proceed with these claims, the Trustee must first establish his standing. This he cannot do.

Standing is a "threshold question in every federal case, determining the power of the court to entertain the suit." Standing depends, first, on whether the plaintiff has identified a "case or controversy" between the plaintiff and the defendants within the meaning of Article III of the Constitution. "To have standing, `[a] plaintiff must [1] allege personal injury [2] fairly traceable to the defendant's allegedly unlawful conduct and [3] likely to be redressed by the requested relief.'" In addition, the plaintiff must comply with "prudential" limitations on standing, of which the salient one here is that a party must "assert his own legal rights and interests and cannot rest his claim to relief on the legal rights or interests of third parties."

The implied prohibition in Article III against third-party standing applies to actions brought by bankruptcy trustees.

In *Caplin v. Marine Midland Grace Trust Co. of N.Y.*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972), the Supreme Court ruled that federal bankruptcy law does not empower a trustee to collect money owed to creditors. That is because a bankruptcy trustee is not empowered "to collect money not owed to the estate"; the trustee's proper task "is simply to collect and reduce to money the property of the estates for which (he is trustee). [N]owhere in the statutory scheme is there any suggestion that the trustee in reorganization is to assume the responsibility of suing third parties" on behalf of creditors. This way, creditors can "make their own assessment of the respective advantages and disadvantages, not only of litigation, but of various theories of litigation," no consensus is needed as to "the amount of damages to seek, or even on the theory on which to sue," and disputes over inconsistent judgments and the scope of settlements can be avoided. [The court then reviews and rejects other similar arguments made by the Trustee].

The Trustee argues that, because SIPC advanced funds to customers at the outset of the liquidation, SIPC is subrogated to those customers' claims against the Defendants; SIPC therefore may assert those claims as subrogee; and Picard is authorized to enforce that right on SIPC's behalf. But SIPC is a creature of statute, and neither the plain language of the statute, nor its legislative history, supports the Trustee's position.

True, a SIPA trustee (unlike a trustee in bankruptcy), advances money to pay claims. The statute takes this fact into account by subrogating SIPC to customers' net equity claims to the extent of the advances they received. But it goes no further.

The Trustee's subrogation theory is premised in § 78fff-3 (a):

> To the extent moneys are advanced by SIPC to the trustee to pay or otherwise satisfy the claims of customers, in addition to all other rights it may have at law or in equity, SIPC shall be subrogated to the claims of such customers with the rights and priorities provided in this chapter, except that SIPC as subrogee may assert no claim against customer property until after the allocation thereof to customers as provided in section 78fff-2(c) of this title.

15 U.S.C. § 78fff-3(a). It is undisputed that the phrase "claims of customers" refers (as throughout the statute) to customers' net equity claims against the estate. SIPA thus allows only a narrow right of subrogation—for SIPC to assert claims against the fund of customer property and thereby recoup any funds advanced to customers once the SIPA trustee has satisfied those customers' net equity claims.

The Trustee urges us to conclude that § 78fff-3(a) does more—much more—by creating a right of subrogation that allows SIPC (and, by extension, the Trustee) to step into customers' shoes and to initiate and control litigation on their behalf, against any number of defendants, until SIPC has been repaid in full. As we emphasized earlier, SIPA grants trustees the "same powers and title with respect to the debtor and the property of the debtor" as a Title 11 trustee, 15 U.S.C. § 78fff-1(a), and the Supreme Court has squarely rejected attempts by Title 11 trustees to capture such litigation. As a final resort, the Trustee relies on a catch-all provision included in the 1978 amendments to SIPA, which states that the subrogation rights afforded by § 78fff-3(a) should not be read to diminish "all other rights [SIPC] may have at law or in equity." 15 U.S.C. § 78fff-3(a). From here, the Trustee claims an implied right of equitable subrogation, "the principle by which an insurer, having paid losses of its insured, is placed in the position of its insured so that it may recover from the third party legally responsible for the loss." He thus claims a wide grant of authority to initiate class-action lawsuits and assert any number of tort claims against third parties on customers' behalf. This is a long, long reach.

There is no sign that Congress intended an expansive increment of power to SIPA trustees.

The Trustee adduces rules of insurance law to justify his claim, an analogy with some intuitive appeal: Principles of equity generally permit subrogees wide scope to sue third-party tortfeasors, a claim that arises most commonly with insurance.

But this argument succumbs to the same critique as Picard's bailment theory: We avoid engrafting common law principles onto a statutory scheme unless Congress's intent is manifest. The clearest Congressional intent here is that we should treat SIPA as a bankruptcy statute, not as an insurance scheme. "SIPA and FDIA are independent statutory schemes, enacted to serve the unique needs of the banking and securities industries, respectively." We have since warned against oversimplified comparisons between insurance law and federal statutory law: "While this Court has referred to SIPC as providing a form of public insurance, it is clear that the obligations imposed on an insurance provider under state law do *not* apply to this congressionally-created nonprofit membership corporation."

Relatedly, Picard argues under principles of equity that unless he can spearhead the litigation on behalf of defrauded customers, the victims will not be made whole, SIPC will be unable to recoup its advances, and third-party tortfeasors will reap windfalls. No doubt, there are advantages to the course Picard wants to follow. But equity has its limits; it may fill certain gaps in a statute, but it should not be used to enlarge substantive rights and powers.

The practical skepticism voiced in *Caplin* in a traditional bankruptcy context is justified here as well. Would such suits prevent customers from "mak[ing] their own assessment of the respective advantages and disadvantages, not only of litigation, but of various theories of litigation"? Can a SIPA trustee control customers' claims against third parties if SIPC has not fully satisfied the customers' claims against the estate? How would inconsistent judgments be avoided, given that "independent actions are still likely because it is extremely doubtful that [the parties] would agree on the amount of damages to seek, or even on the theory on which to sue"? Who would be bound by a settlement entered into by either the Trustee or by each customer who brings suit? *Id.* The size and scope of the litigation here only amplify these concerns.

As *Caplin* advises, it is better to leave these intractable policy judgments to Congress: Congress might well decide that reorganizations have not fared badly in the 34 years since Chapter

X was enacted and that the status quo is preferable to inviting new problems by making changes in the system. Or, Congress could determine that the trustee ... was so well situated for bringing suits ... that he should be permitted to do so. In this event, Congress might also determine that the trustee's action was exclusive, or that it should be brought as a class action on behalf of all [creditors], or perhaps even that the [creditors] should have the option of suing on their own or having the trustee sue on their behalf. Any number of alternatives are available. Congress would also be able to answer questions regarding subrogation or timing of law suits before these questions arise in the context of litigation. Whatever the decision, it is one that only Congress can make.

[It is important to note that the Court did not dismiss the statutory bankruptcy claims, only the common law claims that Piccard attempted to assert against the third parties on behalf of customers. We focus now on the statutory claims contained in the Bankruptcy Code.]

8.2. Fraudulent Transfers – 11 U.S.C. § 548

The Bankruptcy Code contains its own provision allowing the trustee to avoid fraudulent transfers made by the debtor prepetition. It is quite similar in its operation to the Uniform Fraudulent Transfers Act, but gives the recovery to the bankruptcy estate rather than to the creditor seeking to avoid the transfer. It also contains a different limitations period, creating the possibility that the state law period for avoiding fraudulent transfers would be longer than the bankruptcy law period for avoiding fraudulent transfers.

In order for the Trustee to avoid a transfer or obligation under Section 548, the transfer must have taken place, or the obligation must have been incurred, **within two years** before the filing of the petition. 11 U.S.C. § 548(a)(1).

There is one special exception covering transfers to self-settled trusts within **10 years** before bankruptcy. 11 U.S.C. § 548(e)(1). A self-settled trust is a spendthrift trust funded by the debtor and for the benefit of the debtor for the purpose of shielding assets from the claims of the debtor's existing or future creditors. Because of the restriction on the debtor's ability to withdraw or transfer the funds in the trust, the corpus would not constitute property of the estate in the absence of avoidance. *See* 11 U.S.C. § 541(c)(2). For many years, self-settled spendthrift trusts were invalid under state law, but after Alaska led the states by creating this legal mechanism for hiding assets from creditors, other states followed, and it was necessary to add an additional avoiding power to the trustee's arsenal.

The Bankruptcy Code's fraudulent conveyance provisions contain the same basic two-ground test for fraudulent conveyances: either (1) actual intent to hinder, delay or defraud creditors, or (2) received less than reasonably equivalent value, and was or became insolvent (or in an insolvent like condition). 11 U.S.C. § 548(a)(1)(A) and (B). As under the UFTA, value is given when an existing creditor's claim is secured or paid. 11 U.S.C. § 548(d)(2)(A).

8.3. The Trustee's State Law Powers – 11 U.S.C. § 544(b)

Section 544(b) allows the trustee to step into the shoes of a creditor who could avoid a pre-petition transfer under state law. The claim which previously belonged to the creditor now belongs to the estate. This rule is commonly used to allow the trustee to avoid fraudulent transfers under the UFTA that would not be avoidable under Section 548 because of the two year limitations period. It also applies to other state avoidance rules, such as Article 6 of the Uniform Commercial Code enacted in only some states that allows the avoidance of bulk transfers made without following the notice provisions of the UCC.

Hidden from the statutory language is the doctrine of *Moore v. Bay*, 284 U.S. 4 (1931), which allows the trustee to assert the full rights of the estate against the recipient rather than the limited rights of the creditor in whose shoes the trustee has stepped.

Section 544(b) does not give the trustee the power to assert state law claims directly – the trustee must find an actual unpaid creditor on the petition date who could have avoided the transfer under state law. Unless there is an existing creditor on the petition date with standing to avoid the transfer, the trustee has no one's shoes to step into.

8.4. Practice Problems: Fraudulent Transfers

Problem 1. When Doctor Debtor was sued for medical malpractice, he immediately transferred title to his only asset – a house worth $1 million – to his girlfriend as a gift. The plaintiff in the malpractice case knew nothing about the transfer. Two years and one day later, on the eve of trial, Doctor Debtor filed a Chapter 7 bankruptcy proceeding. Can the trustee avoid the transfer of the house to the girlfriend under Section 548?

Problem 2. Suppose the plaintiff's malpractice claim in Problem (1) is determined to be worth $400,000. Dr. Debtor also owed other creditors (credit cards, personal loans, investment guarantees) $350,000. Assume that only the Plaintiff in Problem (1) could avoid the transfer of the home under the UFTA. If the trustee is able to avoid the transfer, how much of the transfer can the trustee avoid? *See* 11 U.S.C. § 544(b), Moore v. Bay, 284 U.S. 4 (1931).

Problem 3. The day before filing bankruptcy, Dr. Debtor entered into a five year employment contract with his girlfriend, promising to pay her $250,000 per year to work as a receptionist in his medical office. Ignoring any claim limitations that we have yet to study, does the trustee have any way to avoid the girlfriend's unsecured claim for the present value of $1,250,000? *See* 11 U.S.C. § 548(a)(1)(B)(ii)(IV).

Problem 4. One week before the start of the trial in Problem (1), Dr. Debtor gave his last $50,000 in cash to his lawyers as a retainer to represent him in the trial. The retainer agreement provided that the $50,000 was a flat fee covering the lawyer's services through trial regardless of the length or amount of work required in the trial, and was to be deemed earned when paid. Can the trustee recover the $50,000 as a fraudulent transfer?

Problem 5. Dr. Debtor's mother loaned him $25,000 one month before bankruptcy. The day before bankruptcy, Dr. Debtor secured his mother's loan with a lien on his medical equipment

worth $35,000, by signing a security agreement, and filing a UCC-1 financing statement with the secretary of state. Can the trustee avoid the security interest as a fraudulent transfer? *See* 11 U.S.C. § 548(d)(2)(A).

Problem 6. Big Corp owns 100% of the stock of Little Corp, as well as 100% of the stock of other subsidiary corporations. Big Corp's bankers require all of Big Corp's subsidiaries to sign guaranties of Big Corp's $20,000,000 line of credit. This is known as an upstream guaranty. Can Little Corp's bankruptcy trustee avoid the guaranty as a fraudulent transfer?

Problem 7. What if Little Corp's lender required Big Corp to guaranty Little Corp's line of credit, and Big Corp filed bankruptcy. This is known as a downstream guaranty. Could Big Corp's trustee avoid the guaranty as a fraudulent transfer?

8.5. Cases on Fraudulent Transfers

8.5.1. BFP v. RESOLUTION TRUST CORPORATION, 511 U.S. 531 (1994)

JUSTICE SCALIA delivered the opinion of the Court.

Petitioner BFP is a partnership, formed by Wayne and Marlene Pedersen and Russell Barton in 1987, for the purpose of buying a home in Newport Beach, California, from Sheldon and Ann Foreman. Petitioner took title subject to a first deed of trust in favor of Imperial Savings Association (Imperial) to secure payment of a loan of $356,250 made to the Pedersens in connection with petitioner's acquisition of the home. Petitioner granted a second deed of trust to the Foremans as security for a $200,000 promissory note. Subsequently, Imperial, whose loan was not being serviced, entered a notice of default under the first deed of trust and scheduled a properly noticed foreclosure sale. The foreclosure proceedings were temporarily delayed by the filing of an involuntary bankruptcy petition on behalf of petitioner. After the dismissal of that petition in June 1989, Imperial's foreclosure proceeding was completed at a foreclosure sale on July 12, 1989. The home was purchased by respondent Paul Osborne for $433,000.

In October 1989, petitioner filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Acting as a debtor in possession, petitioner filed a complaint in bankruptcy court seeking to set aside the conveyance of the home to respondent Osborne on the grounds that the foreclosure sale constituted a fraudulent transfer under § 548 of the Code. Petitioner alleged that the home was actually worth over $725,000 at the time of the sale to Osborne.

The bankruptcy court found, inter alia, that the foreclosure sale had been conducted in compliance with California law and was neither collusive nor fraudulent. The District Court affirmed. A divided bankruptcy appellate panel affirmed. The Court of Appeals for the Ninth Circuit affirmed.

Section 548 of the Bankruptcy Code sets forth the powers of a trustee in bankruptcy (or, in a Chapter 11 case, a debtor in possession) to avoid fraudulent transfers. It permits to be set aside not only transfers infected by actual fraud but certain other transfers as well--so called constructively fraudulent transfers. The constructive fraud provision at issue in this case applies to

transfers by insolvent debtors. It permits avoidance if the trustee can establish (1) that the debtor had an interest in property; (2) that a transfer of that interest occurred within one year of the filing of the bankruptcy petition; (3) that the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and (4) that the debtor received "less than a reasonably equivalent value in exchange for such transfer." 11 U.S.C. § 548(a)(2)(A). It is the last of these four elements that presents the issue in the case before us.

The question presented here, therefore, is whether the amount of debt (to the first and second lien holders) satisfied at the foreclosure sale (viz., a total of $433,000) is "reasonably equivalent" to the worth of the real estate conveyed.

The Courts of Appeals have divided on the meaning of those undefined terms. In *Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201 (1980), the Fifth Circuit, interpreting a provision of the old Bankruptcy Act analogous to § 548(a)(2), held that a foreclosure sale that yielded 57% of the property's fair market value could be set aside, and indicated in dicta that any such sale for less than 70% of fair market value should be invalidated. This "*Durrett* rule" has continued to be applied by some courts under § 548 of the new Bankruptcy Code. [In] *In re Bundles*, the 856 F. 2d 815, 820 (1988), [the] Seventh Circuit rejected the *Durrett* rule in favor of a case-by-case, "all facts and circumstances" approach to the question of reasonably equivalent value, with a rebuttable presumption that the foreclosure sale price is sufficient to withstand attack under § 548(a)(2).

In this case the Ninth Circuit, agreeing with the Sixth Circuit, adopted the position that the consideration received at a non-collusive, regularly conducted real estate foreclosure sale constitutes a reasonably equivalent value under § 548(a)(2)(A). The Court of Appeals acknowledged that it "necessarily part[ed] from the positions taken by the Fifth [and Seventh] Circuits.

In contrast to the approach adopted by the Ninth Circuit in the present case *Durrett* and *Bundles* refer to fair market value as the benchmark against which determination of reasonably equivalent value is to be measured. In the context of an otherwise lawful mortgage foreclosure sale of real estate, such reference is in our opinion not consistent with the text of the Bankruptcy Code. [Court notes that Congress uses "fair market value" in some places in the code, and "reasonably equivalent value" in Section 548]. One must suspect the language means that fair market value cannot--or at least cannot always--be the benchmark.

That suspicion becomes a certitude when one considers that market value, as it is commonly understood, has no applicability in the forced sale context: "The market value of . . . a piece of property is the price which it might be expected to bring if offered for sale in a fair market; not the price which might be obtained on a sale at public auction or a sale forced by the necessities of the owner, but such a price as would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing (but not compelled) to sell and a purchaser who desires to buy but is not compelled to take the particular . . . piece of property." Black's Law Dictionary 971 (6th ed. 1990). In short, "fair market value" presumes market conditions that, by definition, simply do not obtain in the context of a forced sale.

Neither petitioner, petitioner's amici, nor any federal court adopting the *Durrett* or the *Bundles* analysis has come to grips with this glaring discrepancy between the factors relevant to an appraisal of a property's market value, on the one hand, and the strictures of the foreclosure process on the other. Market value cannot be the criterion of equivalence in the foreclosure sale

context. The language of § 548(a)(2)(A) ("received less than a reasonably equivalent value in exchange") requires judicial inquiry into whether the foreclosed property was sold for a price that approximated its worth at the time of sale.

One might judge there to be such a thing as a "reasonable" or "fair" forced sale price. Such a conviction must lie behind the *Bundles* inquiry into whether the state foreclosure proceedings "were calculated . . . to return to the debtor mortgagor his equity in the property." And perhaps that is what the courts that follow the *Durrett* rule have in mind when they select 70% of fair market value as the outer limit of "reasonably equivalent value" for foreclosable property (we have no idea where else such an arbitrary percentage could have come from).

The history of [both fraudulent conveyance and] foreclosure law begins in England, where courts of chancery developed the "equity of redemption"--the equitable right of a borrower to buy back, or redeem, property conveyed as security by paying the secured debt on a later date than "law day," the original due date. The courts' continued expansion of the period of redemption left lenders in a quandary, since title to forfeited property could remain clouded for years after law day. To meet this problem, courts created the equitable remedy of foreclosure: after a certain date the lender would be forever foreclosed from exercising his equity of redemption. This remedy was called strict foreclosure because the borrower's entire interest in the property was forfeited, regardless of any accumulated equity. The next major change took place in 19th century America, with the development of foreclosure by sale (with the surplus over the debt refunded to the debtor) as a means of avoiding the draconian consequences of strict foreclosure. Since then, the States have created diverse networks of judicially and legislatively crafted rules governing the foreclosure process, to achieve what each of them considers the proper balance between the needs of lenders and borrowers. All States permit judicial foreclosure, conducted under direct judicial oversight; about half of the States also permit foreclosure by exercising a private power of sale provided in the mortgage documents. Foreclosure laws typically require notice to the defaulting borrower, a substantial lead time before the commencement of foreclosure proceedings, publication of a notice of sale, and strict adherence to prescribed bidding rules and auction procedures. Many States require that the auction be conducted by a government official, and some forbid the property to be sold for less than a specified fraction of a mandatory presale fair market value appraisal.

When these procedures have been followed, however, it is "black letter" law that mere inadequacy of the foreclosure sale price is no basis for setting the sale aside, though it may be set aside (under state foreclosure law, rather than fraudulent transfer law) if the price is so low as to "shock the conscience or raise a presumption of fraud or unfairness."

Fraudulent transfer law and foreclosure law enjoyed over 400 years of peaceful coexistence in Anglo American jurisprudence until the Fifth Circuit's unprecedented 1980 decision in *Durrett*. To our knowledge no prior decision had ever applied the "grossly inadequate price" badge of fraud under fraudulent transfer law to set aside a foreclosure sale. To say that the "reasonably equivalent value" language in the fraudulent transfer provision of the Bankruptcy Code requires a foreclosure sale to yield a certain minimum price beyond what state foreclosure law requires, is to say, in essence, that the Code has adopted *Durrett* or *Bundles*. Surely Congress has the power pursuant to its constitutional grant of authority over bankruptcy, U. S. Const., Art. I, § 8, cl. 4, to disrupt the ancient harmony that foreclosure law and fraudulent conveyance law, those two pillars of debtor creditor jurisprudence, have heretofore enjoyed. But absent clearer textual guidance than the

phrase "reasonably equivalent value"--a phrase entirely compatible with pre-existing practice--we will not presume such a radical departure.

Federal statutes impinging upon important state interests "cannot . . . be construed without regard to the implications of our dual system of government. . . . [W]hen the Federal Government takes over . . . local radiations in the vast network of our national economic enterprise and thereby radically readjusts the balance of state and national authority, those charged with the duty of legislating [must be] reasonably explicit." It is beyond question that an essential state interest is at issue here: we have said that "the general welfare of society is involved in the security of the titles to real estate" and the power to ensure that security "inheres in the very nature of [state] government."). Nor is there any doubt that the interpretation urged by petitioner would have a profound effect upon that interest: the title of every piece of realty purchased at foreclosure would be under a federally created cloud. (Already, title insurers have reacted to the *Durrett* rule by including specially crafted exceptions from coverage in many policies issued for properties purchased at foreclosure sales. To displace traditional State regulation in such a manner, the federal statutory purpose must be "clear and manifest." Otherwise, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law.

For the reasons described, we decline to read the phrase "reasonably equivalent value" in § 548(a)(2) to mean, in its application to mortgage foreclosure sales, either "fair market value" or "fair foreclosure price" (whether calculated as a percentage of fair market value or otherwise). We deem, as the law has always deemed, that a fair and proper price, or a "reasonably equivalent value," for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with.

This conclusion does not render § 548(a)(2) superfluous, since the "reasonably equivalent value" criterion will continue to have independent meaning (ordinarily a meaning similar to fair market value) outside the foreclosure context. Indeed, § 548(a)(2) will even continue to be an exclusive means of invalidating some foreclosure sales. Although collusive foreclosure sales are likely subject to attack under § 548(a)(1), which authorizes the trustee to avoid transfers "made . . . with actual intent to hinder, delay, or defraud" creditors, that provision may not reach foreclosure sales that, while not intentionally fraudulent, nevertheless fail to comply with all governing state laws. Any irregularity in the conduct of the sale that would permit judicial invalidation of the sale under applicable state law deprives the sale price of its conclusive force under § 548(a)(2)(A), and the transfer may be avoided if the price received was not reasonably equivalent to the property's actual value at the time of the sale (which we think would be the price that would have been received if the foreclosure sale had proceeded according to law).

8.5.2. ALLARD v. FLAMINGO HILTON, 69 F.3d 769 (6th Cir. 1995)

The debtors, George and Nikki Chomakos, filed a bankruptcy petition on August 2, 1990, after having lost several thousand dollars at a casino operated by Flamingo Hilton Corporation in Las Vegas, Nevada. The petition sought relief under Chapter 11 of the Bankruptcy Code, but the matter was soon converted into a Chapter 7 case.

The trustee in bankruptcy subsequently commenced an adversary proceeding against Flamingo. The trustee's complaint alleged that Mr. and Mrs. Chomakos had been insolvent for six

years prior to the filing of the petition; that during this time Nikki Chomakos transferred various sums to Flamingo for the purpose of gambling; that she made some of these transfers during the year preceding the filing; and that she did not receive a reasonably equivalent value or fair consideration in exchange. The complaint was subsequently amended to allege that George Chomakos had also made losing bets at the casino while insolvent. Invoking 11 U.S.C. Sec. 548(a), the trustee sought to recover under that section losses incurred during the year preceding the bankruptcy filing. Under Michigan's version of the Uniform Fraudulent Conveyance Act, the trustee sought to recover losses incurred throughout the entire six-year period in which Mr. and Mrs. Chomakos were alleged to have been insolvent.

[T]he bankruptcy court found that the debtors should be deemed to have been insolvent from and after January of 1988; that at various times in June and September of 1989 Nikki Chomakos won a total of $9,000 playing slot machines at the Flamingo casino, while losing a total of $14,000; and that George Chomakos lost a net amount of $2,710 at the casino after January of 1988 and before the filing of the petition. The combined net losses of the two debtors during the period when they were insolvent came to $7,710.

In an opinion, the bankruptcy court held that the relief requested by the trustee should be denied because defendant Flamingo gave reasonably equivalent value in exchange for the debtors' money. The district court affirmed the decision.

The point in time as of which we must determine whether Mr. and Mrs. Chomakos received property of reasonably equivalent value in exchange for the money they wagered at the casino is the point at which their bets were placed. Where gambling is lawful, as it was in the case at bar, the placing of a bet gives rise to legally enforceable contract rights. These contract rights constitute "property," of course, and at the time which Collier identifies as "critical"--a time before anyone can know whether the bet will be successful--the property has economic value. The property is not unlike futures contracts purchased on margin. The investor in futures may win big, or his position may be wiped out, but the contractual right to a payoff if the market happens to move the right way at the right time constitutes a value reasonably equivalent to the money at risk.

The trustee's brief takes the bankruptcy court to task for making the suggestion--a suggestion characterized by the trustee as "incredible"--that gambling is arguably "an 'investment' that can have economic value...." But the trustee looks at the picture only as of the time when Mr. and Mrs. Chomakos left the casino "with nothing in exchange for the monies they gambled away." The time that counts is not the time when the bet is won or lost, but the time when the bet is placed. The "investment" may turn out badly, but unless and until it does, the contractual right to receive payment in the event that it turns out well is obviously worth something.

Take blackjack, for instance. The trial record shows that a person who bets $2 at the blackjack table where Mr. Chomakos did his gambling will win $3 if he receives a black jack. At the point in time when Mr. Chomakos placed a $2 bet, his chance of winning $3 had an economic value.

The existence of an economic value may be immaterial, however, if the dollar value of the gambler's chance of winning--augmented, perhaps, by an element of entertainment value--is not "reasonably equivalent" to the amount of money wagered. We believe that the evidence presented by Flamingo showed a reasonable equivalency here, and the trustee presented no evidence to the contrary.

The casino's evidence showed, among other things, that the gambling business in Nevada is closely regulated by the state; that this regulation extends to payout ratios for both slot machines and table games; that casinos depend on repeat business, which is encouraged by customers winning; and that competition among casinos is intense. The evidence further showed that a three dollar slot machine bet could produce a jackpot of over a million dollars, which would be paid on the spot; that in a single year, Flamingo slot machine players had more than 9,500 jackpots of $1,200 or more, in addition to many lesser jackpots; that for all the dollars deposited in all Flamingo slot machines over the course of a year, Flamingo paid out 94 percent in winnings; and that the payout ratio for the particular machines played by Mrs. Chomakos was even higher, ranging from 95.73 percent to 97.43 percent. The customer enjoys better odds at the blackjack table, moreover. Assuming the blackjack player has a fair knowledge of the game and uses good basic strategy, the evidence showed that the house advantage is only one percent or less.

The trustee disputes none of these facts and does not seriously challenge Flamingo's good faith. Looking at the situation from the standpoint of creditors, however, the trustee argues that the very existence of a house advantage, coupled with the fact that Mr. and Mrs. Chomakos ultimately lost more than they won, means that there was no reasonably equivalent economic benefit. And citing *In re Young*, 148 B.R. 886 (Bankr.D.Minn.1992), aff'd 152 B.R. 939 (D.Minn.1993), where church contributions made by an insolvent donor were held to be fraudulent conveyances, the trustee maintains that it would be anomalous for gambling losses not to be treated as fraudulent conveyances too.

As far as church contributions are concerned, the cases are in conflict. While the Young donor was held not to have received reasonably equivalent value, bankruptcy courts reached a contrary result in *In re Missionary Baptist Foundation of America, Inc.*, 24 B.R. 973 (Bankr. N.D. Tex.1982), and *In re Moses*, 59 B.R. 815 (Bankr. N.D. Ga.1986). There is no need for us to take sides in the church contribution controversy, however. Looking at the matter from the standpoint of creditors, as the trustee urges us to do, it seems reasonably clear that the intangible property rights accruing to Mr. and Mrs. Chomakos when they placed their bets differed significantly from the benefits accruing to the donors in the church contribution cases.

A debtor who contributes to a church may receive spiritual and social returns of great value to the debtor, but such returns are not likely to be of much benefit to creditors. A debtor who places a bet in a fair and lawful game of chance, on the other hand, may receive hard cash in return. On one of the days when Mrs. Chomakos played Flamingo's slot machines, for example, she had winnings of $5,000. Suppose she had won a $5,000 jackpot at the start of her visit to the casino and had stopped playing as soon as she won; the return on her "investment" would obviously have benefited her creditors.

It is true that gambling odds always favor the house, and that Mrs. Chomakos would have been almost certain to lose her $5,000 jackpot--and more--if she continued playing long enough. On the record before us, however, we cannot say that the existence of a modest house advantage means that unsuccessful bets are fraudulent conveyances.

The trustee argues that Mr. and Mrs. Chomakos did not occupy a bargaining position equal to Flamingo's, and the gambling transactions were therefore not at arm's length. But this argument overlooks the governmental and business forces by which Flamingo was constrained. Flamingo was subject to state regulations designed to create a reasonably level playing field, and Flamingo

had to compete with nearby casinos to which Mr. and Mrs. Chomakos and all other customers were free to take their business. Without reasonably generous payouts and competitive odds, Flamingo could not hope to attract the repeat customers on whom, according to the evidence, Flamingo and other casino operators depend for survival. "[T]he quid pro quo," as the bankruptcy court observed, "was established in the context of a state regulated business, existing in an open competitive marketplace responding and responsive to desires of legitimate tourists pursuing and engaging in a legal and legitimate pursuit."

As far as federal law is concerned, moreover, we are not persuaded that we ought to evaluate the transactions at issue here solely from the standpoint of creditors. Casino patrons receive what the bankruptcy court called "psychic and other intangible values," just as patrons of a fine restaurant do, for example. *Id.* at 593. If, instead of gambling, Mr. and Mrs. Chomakos had spent $7,710 on expensive dinners, the creditors would have been no better off than they are now. Yet the trustee concedes that the restaurateur would not be liable for return of the money--and when asked at oral argument how money spent at a blackjack table differs from money spent at a dinner table, the trustee had no satisfactory answer.

8.5.3. Introduction to *Bakersfield Westar*

The following case is very interesting, but also very complex because it requires some understanding of federal partnership tax law. A corporation that makes an “S” election is not a taxable entity. Instead, the shareholders of the “S corporation” pay taxes on all of the corporation’s activities. On the other hand, a corporation without an “S” election (a so-called “C” corporation) is taxed on its own activities, with the shareholder paying a second level of taxes on corporate dividends.

Bakersfield Westar Corporation took out large loans secured by its assets. The receipt of loan proceeds is not taxable income because Bakersfield had an obligation to repay the loan proceeds. However, if Bakersfield later does not have to repay the loan proceeds for some reason, then Bakersfield will, at the time of receiving loan forgiveness, have to pay taxes on the original loan proceeds that were received without tax because of the obligation to repay. This is known as “cancellation of indebtedness income.”

Bakersfield Westar also had large tax losses from its operations that passed through to the Saunders while the corporation was in S status, allowing the Saunders to use the losses to offset their income, but not allowing the corporation to use its own tax losses against any future income.

By revoking the S election, the Saunders sought to keep the benefit of tax losses that they got from Bakersfield Westar during the S election period, while saddling the bankruptcy estate rather than them with the tax liability for not repaying the loans and with the gains from the sale or foreclosure of the corporation’s assets due to depreciation deductions passed through to the Saunders. If allowed, the revocation of the “S” election allowed the Saunders to receive the benefit of the corporation’s earlier tax deductions and use of loan proceeds tax free, without having to pay taxes on the gains and cancellation of indebtedness income generated by those tax deductions and exclusions, while forcing the creditors of the corporation to bear the burden of the taxes.

8.5.4. IN RE BAKERSFIELD WESTAR, INC., 226 B.R. 227 (9th Cir. BAP 1998)

Bakersfield Westar provided air and ground ambulance services in Kern County, California. Bakersfield's president, appellee Craig R. Saunders, and his wife, appellee Jodie K. Saunders, co-owned 100% of Bakersfield's stock as community property.

On January 1, 1992, Craig Saunders submitted to the Internal Revenue Service an election to have Bakersfield treated as a subchapter S corporation for federal income tax purposes, beginning with tax year 1992. On February 1, 1994, Mr. Saunders submitted to the IRS a statement of revocation of Bakersfield's subchapter S election, together with a statement of the Saunders' consent to the revocation of the election. The legal effect of the statement of revocation, which the IRS deemed effective as of February 1, 1994, was to make Bakersfield a "C" corporation (i.e., a separate taxable entity) for federal income tax purposes.

The Saunders filed a voluntary chapter 7 petition on February 14, 1994. The trustee in the Saunders' bankruptcy case filed a voluntary chapter 7 petition on behalf of Bakersfield (hereinafter the "debtor") on March 4, 1994. Due to the prepetition revocation of the debtor's subchapter S election (the "Revocation"), the debtor's bankruptcy estate did not succeed to the debtor's subchapter S tax attributes because the attributes had already passed through to the Saunders.

The trustee in Bakersfield Westar's bankruptcy case filed an adversary proceeding in March 1996 against the Saunders, the Saunders' bankruptcy trustee, and the IRS, seeking to avoid the Revocation as a fraudulent transfer under §§ 544(b) and 548, and Cal. Civ. Code § 3439 et seq.

The complaint alleged that the Saunders submitted the Revocation to the IRS with the intent to shift to the debtor the significant capital gains tax burden that would arise from the future sale or other disposition (e.g., foreclosure) of the debtor's assets, and with the actual intent to hinder, delay, and defraud creditors. The complaint alleged in the alternative that the debtor received less than a reasonably equivalent value in exchange for the Revocation. The Saunders' and the IRS's answers to the complaint denied the material allegations, and the IRS's answer contended that applicable treasury regulations provided the exclusive means by which a taxpayer's revocation of a subchapter S election could be rescinded or set aside.

In October 1996, the trustee moved for partial summary judgment to avoid the Revocation as a fraudulent transfer under § 548(a)(1) on the grounds that the debtor's right to make or revoke its subchapter S election was "property," and the Revocation of that election was a "transfer" within the meaning of § 548. The motion included the IRS as a respondent because the trustee requested an order directing the IRS to disregard the Revocation and reinstate the debtor's subchapter S status, retroactive to the date the Revocation was deemed effective, in order to restore the status quo ante.

The trustee analogized the "property" in this case to a debtor's right to carry forward a net operating loss ("NOL"), which he contended has been recognized as "property" by several courts. He analogized the "transfer" in this case to a debtor's election to carry forward NOLs, which he contended those courts have recognized as a "transfer" of property.

The trustee contended that the debtor's election to be treated as a subchapter S corporation constituted a valuable property right because its corporate status allowed the debtor to pass its (and

hence the bankruptcy estate's) tax liabilities through to its shareholders, the Saunders. He argued that the specific value of the election consisted of the debtor's ability to pass to the Saunders the debtor's estate's capital gains taxes resulting from the sale of over $230,000 in assets and from the future disposition of approximately $2 million in assets through foreclosure.

The trustee asserted that the Revocation constituted a "transfer" because it caused the debtor to "dispose" of its right (and thus the estate's right) to pass its tax liabilities through to the Saunders. As a result of the Revocation, the estate's substantial capital gains tax liabilities remained an obligation of the estate and its creditors, rather than an obligation of the Saunders.

The trustee also argued that the Revocation was made with the actual intent to hinder, delay, and defraud creditors. He contended that the following "badges of fraud" demonstrated the necessary intent: the debtor's failure to receive any direct or indirect value or benefit from the Revocation; the lack of any consideration received for the Revocation; the fact that the transferee, Mr. Saunders, was an officer of the debtor; and the debtor's insolvency (which the trustee inferred from the timing of the Revocation, i.e., about two weeks before the filing of the Saunders' bankruptcy case, and about one month before the filing of the debtor's bankruptcy case).

The IRS's opposition acknowledged that several courts have recognized the right to exercise NOL elections as "property" within the meaning of the Code, but argued that the right to make or revoke a corporation's subchapter S election cannot constitute "property" under § 548 because it has no present value to a taxpayer, is not referenced in the Code, and has not been recognized by any court to constitute "property." The IRS emphasized that a taxpayer's revocation of a subchapter S election has merely the prospective economic impact of changing the tax ramifications of future corporate transactions, and that the Revocation in this case did not deprive the debtor-corporation (or the bankruptcy estate) of anything of economic value, in contrast to the immediate tax consequences which arise from the exercise of NOL elections. The IRS again asserted that the Tax Code provides the exclusive means by which a corporation's subchapter S election may be revoked.

The Saunders' opposition and counter-motion for summary judgment argued that the trustee could not avoid the Revocation under § 548(a) because only a corporation's shareholders could elect or revoke a corporation's subchapter S status. They also claimed that Mr. Saunders lacked the necessary actual fraudulent intent because the Revocation was made on the advice of professionals.

The trustee's response asserted that the Revocation deprived the bankruptcy estate of tax attributes it would have otherwise enjoyed, which he argued was similar in nature to the decision to carry forward NOLs, and that the amount of funds available to pay the estate's creditors would be substantially diminished due to the significant tax liabilities caused by the Revocation.

At a hearing on the motion and counter-motion on October 30, 1996, the court concluded that the Revocation was not a voluntary or involuntary transfer by the debtor of property or an interest in property, and the right to make or revoke a subchapter S election was not "property" or an "interest in property" within the meaning of the Code. The court also determined that the trustee had failed to establish the elements of § 548(a). In support of its conclusions, the court stated:

> Section 548 talks about transfers made by the debtor. This was not a transfer made by the debtor. The debtor is wholly neutral and ineffective

> to do anything at all with regard to subchapter S elections or revocations. It's purely within the province of the shareholders to do so.

Transcript of Proceedings October 30, 1996, p. 7.

> [T]here's no recognition that the corporation has benefited or is subject to detriment because of [the election]. The only thrust of the subchapter S election is what the shareholder wants to do about the shareholder's tax liability.

Transcript of Proceedings October 30, 1996, p. 11.

> The corporation had nothing to do with the election, it had nothing to do with the revocation. I cannot find — and that's only one element of the finding — that that could ever be deemed property, apart from any further finding that it was a result — that there was intent on the part of the — there was a requisite intent.
>
> But I think the basic concern, at least with respect to the granting of the countermotion for summary judgment, is that this was not — that the debtor did not do the transfer, that it was not an involuntary transfer, and that it was not an interest of the debtor.

Transcript of Proceedings October 30, 1996, pp. 16-17.

The [bankruptcy] court denied the trustee's motion, and granted the Saunders' countermotion. The court *sua sponte* dismissed the IRS as a defendant, although the IRS had not filed a joinder in the counter-motion, and dismissed the complaint in its entirety. The Saunders' counsel transmitted a proposed judgment and order to the court in November 1996.

Section 548(a)(1) [9] of the Code, under which the trustee brought his motion for partial summary judgment, allows a trustee to avoid any fraudulent "transfer" of "an interest of the debtor in property." The IRS acknowledges that the Code does not define "interest of the debtor in property." However, the IRS repeats its argument from the proceedings below that a debtor's prepetition right to revoke its election under I.R.C. § 1362, to be treated as a subchapter S corporation, is not an "interest of the debtor in property" within the meaning of § 548, because the right has no present value to a taxpayer, and has not been recognized by any court as constituting "property

We disagree. This argument unduly limits the definition of "property" to those rights which have a quantifiable "present value." Even if the definition were limited to this extent, the right in question has value to a debtor's estate and is therefore properly characterized as "property." In addition, the IRS's assertion that the right has not been recognized as "property" under the Code is incorrect.

In the absence of federal law, state law determines whether a debtor possesses an interest in property. However, a debtor's subchapter S status is a creation of I.R.C. § 1362, and federal law therefore determines whether a debtor holds a "property" interest in its subchapter S status

The United States Supreme Court has defined an "interest of the debtor in property" as "that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings."

"Property of the debtor" is also defined broadly under Ninth Circuit case law. "Generally, property belongs to the debtor for purposes of § 547 if its transfer will deprive the bankruptcy estate of something which could otherwise be used to satisfy the claims of creditors." *See also In re Kimura*, 969 F.2d 806, 810 (9th Cir. 1992) (defining property as "generally characterized as an aggregate of rights; `the right to dispose of a thing in every legal way, to possess it, to use it, and to exclude everyone else from interfering with it.'")

A corporation's right to use, enjoy and dispose of its subchapter S status has been held to fall within this broad definition of "property." In re Trans-Lines West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn.1996). The bankruptcy court in Trans-Lines held on virtually identical facts that a debtor-corporation's right to revoke its subchapter S status constituted "property" under the Code. Id. at 661.

The court focused on § 1362(c), which provides:

> An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

Thus, the court reasoned, once a corporation elects to be treated as a subchapter S corporation under subsection (a), the right of the corporation to use and enjoy that status is guaranteed under subsection (c) until the corporation elects to terminate the status under subsection (d). The bankruptcy court held that the debtor therefore possessed a property interest, "i.e., a guaranteed right to use, enjoy and dispose of that interest," in its subchapter S status. 203 B.R. at 661. This holding is consistent with the Ninth Circuit's definition of "property."

Furthermore, the fact that a right may be prospective in nature does not place it outside the definition of "property." "The main thrust of [§ 541's predecessor under the Act] is to secure for creditors everything of value the [debtor] may possess. . . . To this end the term property has been construed most generously and an interest is not outside its reach because is it novel or contingent or because its enjoyment must be postponed." *Segal v. Rochelle*, 382 U.S. 375, 379, 86 S. Ct. 511, 15 L.Ed.2d 428 (1966) (declining to exclude the right to NOL carry forwards from definition of property merely because right was intangible and not yet reduced to a tax refund).

The ability to not pay taxes has a value to the debtor-corporation in this case. It is estimated that the debtor passed through to the Saunders approximately $2,359,109.00 in taxable losses from its operations during the period between September 30, 1992, and January 1, 1994, while holding its subchapter S status. It is further estimated that the debtor's estate will sustain approximately $400,000.00 in capital gains taxes from the sale and other disposition of its assets during bankruptcy as a result of the Revocation of that status.

The debtor's estate will be required to pay the capital gains taxes on an administrative expense priority basis, and its payment of the taxes will diminish the amount of monies that would otherwise be available to satisfy claims of the debtor's remaining creditors. If the Revocation had not occurred, the Saunders (and thus the creditors of their bankruptcy estate) would have been responsible for payment of these tax liabilities.

Accordingly, we hold that the debtor's prepetition right to make or revoke its subchapter S status constituted "property" or "an interest of the debtor in property" within the meaning of the Code.

2. Whether the debtor's prepetition revocation of its corporate status election constitutes a "transfer" that may be avoided by a trustee under § 548(a)

The term transfer, as used throughout the Code, is defined as follows:

> "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;"

11 U.S.C. § 101(54).

The fraudulent transfer doctrine prohibits the transfer of a debtor's property with either the intent or effect of placing the property beyond the reach of its creditors. The underlying purpose of § 548 is to preserve assets of the estate for creditors.

Toward that end, Congress has afforded bankruptcy trustees extraordinary powers to avoid and recover transfers in order to preserve the bankruptcy estate.

The Saunders concede, however, that their decision to revoke the corporation's subchapter S status was based upon the recommendation of their professionals. The Revocation was made approximately two weeks prior to their filing personal bankruptcy. It is highly unlikely that the Saunders' professionals would have failed to inform them of the effect of the Revocation on their personal tax obligations and those of the corporation. It is equally difficult to believe that the Saunders's professionals would have failed to discuss with them the possibility that the corporation would also be forced to file bankruptcy and, if that were to happen, that a trustee might sell the debtor's assets and incur significant capital gains taxes as a result.

Thus, the decision to revoke the debtor's subchapter S status appears to reflect careful tax planning, and the Revocation appears to represent an effort by the Saunders to manipulate the bankruptcy system to their personal advantage under the guise of professional tax planning.

[T]he trustee in this case has the power to avoid the debtor's revocation of its subchapter S status. This result is consistent with the underlying purpose of § 548.

The IRS contends that application of § 548 would directly conflict with the Tax Code provisions that regulate subchapter S elections. It insists that the general provisions of § 548 should not be read to override the specific provisions of the Tax Code regarding revocation of subchapter S elections, absent some specific statutory provision granting bankruptcy trustees rights that are not otherwise found in the Tax Code. The IRS and the Saunders both contend that courts have strictly construed the Tax Code provisions regarding subchapter S corporations, and rejected all efforts to expand their scope and application.

However, courts have long held that Code provisions may override provisions of the Tax Code, even absent specific Congressional or statutory authorization to do so. Furthermore, the cases cited by the IRS and the Saunders regarding restrictive interpretation of the Tax Code's subchapter S provisions concern the effect of the subchapter S provisions on shareholders'

individual tax obligations outside of bankruptcy. The cases have no relevance to a trustee's power to avoid a revocation under § 548.

The IRS and the Saunders also both argue that revocation of a corporation's subchapter S election can only be made with the consent of the corporation's shareholders. They argue that a trustee does not succeed to a corporation's statutory right to make the revocation when the corporation files bankruptcy and, if the Saunders had not made the revocation in this case, the trustee would not have succeeded to their right to do so. In contrast, a bankruptcy estate is specifically authorized under the Tax Code to succeed to a debtor's right to waive NOL carry backs.

This argument fails to distinguish between "avoidance" under the Code in the bankruptcy context, and "revocation" of an otherwise irrevocable election under the Tax Code outside of bankruptcy.

The IRS also expressed fears that "administrative havoc" will ensue if trustees are allowed to avoid revocations of subchapter S elections. In this case, the IRS complains that it might be forced to adjust shareholders' personal income tax returns if trustees are allowed to avoid otherwise valid subchapter S elections. An S corporation may now have more than 75 shareholders in any given year, and the IRS could "conceivably" be forced to adjust all of their personal tax returns, regardless of whether they were parties to the § 548 action or the fraud alleged by the trustee. The IRS contends that the situation would be particularly problematic if avoidance of the election under § 548 were to conflict with the Tax Code's statute of limitations for adjustments to corporate and individual tax returns.

This argument is unpersuasive. The IRS acknowledges that the concern is speculative. It routinely adjusts individual and corporate tax returns in the ordinary course of its business. The possibility that the IRS might be required to amend an unknown (and possibly limited) number of additional tax returns in any given year is not an unusual occurrence and certainly will not create "administrative havoc."

8.6. The Strong Arm Power – 11 U.S.C. § 544(a)

The strong arm power gives the trustee the power to set aside unperfected liens and transfers. As you will recall, under Article 9 of the Uniform Commercial Code a judicial lien creditor has priority over a security interest that is neither "filed nor perfected" at the time the judicial lien attaches to the property. Therefore, most security interests that are not perfected as of the petition date can be set aside by the trustee using the trustee's status as a judicial lien creditor. 11 U.S.C. § 544(a)(1).

With respect to real estate, the trustee has the power of a bona fide purchaser for value without notice of a prior lien. 11 U.S.C. § 544(a)(3). This similarly gives the trustee the power to avoid mortgages and deeds that have not been perfected prepetition by recording in the county real property records. When a lien is avoided under the strong arm powers, the creditor is relegated to the status of an unsecured creditor.

The problems demonstrate some statutory limitations to the strong arm powers that are not apparent on the face of the statute. The cases that follow show just how strong the trustee's statutory strong arm powers are, even in the face of compelling equities.

8.6.1. Practice Problems: The Strong Arm Power

Answer the following questions:

Problem 1. Corporate debtor borrows $20,000 from FinanceBank to purchase a new piece of business equipment on July 1, signing a promissory note and security agreement. Finance Bank did not file UCC-1 Financing Statement with the Secretary of State. In order to have a purchase money security interest, Finance Bank paid the $20,000 in loan proceeds directly to the seller of the equipment. On July 15, the equipment was delivered to the debtor. On July 20, the debtor files a Chapter 11 bankruptcy petition. Can the trustee avoid FinanceBank's security interest? Can FinanceBank perfect its security interest post-petition without getting relief from the automatic stay? How much time does FinanceBank have after the debtor files bankruptcy to file its UCC-1 financing statement? Consider UCC § 9-317(e), 11 U.S.C. §§ 546(b), 362(b)(3).

Problem 2. Would your answer to Problem (1) change if the Bank issued the check to the debtor, and the debtor used other money to purchase the equipment.

Problem 3. Georgio's Italian Ices entered into a 20 year lease with Beachfront Properties, Inc., the owner of a strip of retail stores on a popular tourist strip in Malibu, California, and has been operating the store for several years. The lease was never recorded, however. Can the trustee in Beachfront's bankruptcy case use his or her strong arm powers to avoid Georgio's lease and kick it out of the premises?

8.6.2. Cases on the Strong Arm Power

8.6.2.1. IN RE PROJECT HOMESTEAD, INC., 374 B.R. 193 (Bankr. MD NC 2007)

Prior to ceasing operations during the latter part of 2003, the Debtor, a North Carolina non-profit corporation, was engaged in the business of developing and selling affordable housing to low and moderate income purchasers in North Carolina. Each of these six adversary proceedings involves a residence that the Debtor purportedly sold to a purchaser in 2003 (the "Properties"). The plaintiffs in these proceedings are Commonwealth Land Title Insurance Company ("Commonwealth") and various lenders who hold promissory notes and deeds of trust from the individuals who purchased the residences from the Debtor (the "Lenders"). Commonwealth issued Closing Protection Letters when the residences were purchased. The defendants in these proceedings are William P. Miller, the Chapter 7 trustee for the Debtor (the "Trustee"), and the individuals who purchased the residences (the "Purchasers").

Although each of these proceedings arises out of a separate transaction, the fact patterns involved in the transactions are very similar. In each case, the Purchasers entered into purchase

contracts with the Debtor and obtained loans in order to finance the purchase of their homes. Closings, or what the parties understood to be closings, were scheduled in early 2003 and held in each case in order to consummate the purchases. The closing attorney for each of the closings was an attorney named Armina Swittenberg. Prior to the closings, the Lenders who had extended loans to the Purchasers wired the loan proceeds to Ms. Swittenberg's trust account. At each closing, one or more representatives of the Debtor and the respective Purchasers were present. At each closing, the Debtor received the purchase price of the property, including the portion that was paid from the loan proceeds that had been wired to Ms. Swittenberg, and a duly executed deed from the Debtor was delivered to the Purchasers that purportedly conveyed the property to the Purchasers. At each closing, the Purchasers executed a promissory note in favor of the Lender, along with a deed of trust purportedly granting the Lender a lien on the property being purchased to secure the promissory note. The deed from the Debtor and the deed of trust from the Purchasers were left with Ms. Swittenberg so that she could record the deed and deed of trust. Each of the properties involved in the six closings was encumbered by a pre-existing deed of trust from the Debtor and in each case Ms. Swittenberg retained a sufficient amount of funds at the closing to pay off the indebtedness secured by the pre-existing deed of trust. In each instance, Ms. Swittenberg, in fact, did pay off the indebtedness secured by the pre-existing deed of trust. However, Ms. Swittenberg failed to record either the deeds from the Debtor or the deeds of trust from the Purchasers to their Lender and none of the deeds or the deeds of trust had been recorded when the Debtor filed its Chapter 7 petition on January 24, 2004.

These adversary proceedings were filed on November 4, 2005, The plaintiffs allege a controversy with the Trustee regarding whether the bankruptcy estate has any beneficial interest in the properties and seek declaratory relief that would establish the Purchasers as the owners of the properties in question and establish a first lien in favor of the Lenders securing the indebtedness due under the promissory notes that were executed by the Purchasers. The Trustee denies that the plaintiffs are entitled to the relief sought in these proceedings and has asserted a counterclaim against the plaintiffs and a crossclaim against the Purchasers seeking an adjudication that as bankruptcy trustee, he holds title to the properties in question free and clear of all unrecorded interests, including any claims or interests of the plaintiffs or the Purchasers. The plaintiffs and the Trustee both assert that there are no material issues of fact and seek summary judgment in their favor.

The plaintiffs seek a declaratory judgment that: (a) a constructive trust was created in favor of the Purchasers as of dates prior to the petition date; (b) that on the petition date, only the bare legal title to the properties came into the Debtor's estate; and (c) that the Trustee be ordered to transfer the legal title to the properties to the Purchasers.

Plaintiffs base their claim upon state law regarding the imposition of constructive trusts and section 541(d) of the Bankruptcy Code. Plaintiffs argue that under applicable North Carolina law, the Purchasers are entitled to have a constructive trust imposed with respect to the Properties and that under North Carolina law such constructive trusts relate back to the conduct giving rise to such constructive trusts which, in each case, was prior to the petition date. As a result of the constructive trust, plaintiffs maintain that on the petition date the Purchasers held equitable title, the Debtor held only bare legal title and section 541(d) therefore operates to exclude the properties from the bankruptcy estate and place the properties beyond the reach of the Trustee's powers under section 544(a)(3).

While not conceding that the Purchasers are entitled to a constructive trust, the Trustee argues that even if a constructive trust were imposed, the Trustee's rights under section 544(a)(3) are not subordinate to a constructive trust and that as a bona fide purchaser for value under section 544(a)(3), he is entitled to prevail over any rights of the Purchasers under a constructive trust.

The issue thus presented is whether section 541(d) trumps the Trustee's rights and powers under section 544(a)(3). As noted by both parties, there is a split of authority regarding the issue. This court agrees with the reasoning and conclusion of the court in *In re Reasonover*, 236 B.R. 219 (Bankr. E.D. Va. 1999), that section 541(d) does not trump the trustee's rights and powers under section 544(a)(3).

As pointed out in *Reasonover*, most of the decisions reaching a contrary result do not discuss or take into account the 1984 amendments to section 541(d). Prior to those amendments, section 541(d) referred to property that became property of the estate under "subsection (a)." The 1984 amendments significantly modified the language of section 541(d) by deleting "subsection (a)" and replacing it with "subsection (a)(1) or (2)." This court agrees with the conclusion that "[b]y excluding from the operation of § 541(d) those portions of § 541(a) other than subsections (a)(1) and (a)(2), Congress clearly signaled its intention that the trustee's avoidance powers would trump claims based solely on the debtor's lack of equitable title."

The decision in *Reasonover* also supports the Trustee' argument that under section 544(a)(3) no transfer is required in order for a bankruptcy trustee to have the rights and powers of a bona fide purchaser of real property. As pointed out in *Reasonover*, the text of section 544(a)(3) not only does not limit the trustee's avoidance powers to transfers "by" the debtor, it is not even limited to "transfers." This means that in these proceedings, if a bona fide purchaser of the Properties from the Debtor would have acquired a superior right and title as against the Purchasers or entities claiming through the Purchasers, then so does the Trustee.

While a bankruptcy trustee's rights and powers as a bona fide purchaser of real property are created or conferred by federal bankruptcy law, the extent of the trustee's rights as a bona fide purchaser are measured by applicable state law

The Trustee argues that under North Carolina law, even if the Purchasers were granted a constructive trust, his rights as a bona fide purchaser of real property are superior to the rights of the Purchasers as the beneficiaries of the constructive trust. The Trustee's argument is fully supported by North Carolina law under which the interests of a bona fide purchaser of real property without notice of the trust are superior to the rights of a beneficiary of an unrecorded equitable trust.

8.6.2.2. IN RE LOUISE CARY MORENO, 293 B.R. 777 (Bankr. D. Col. 2003)

The parties raise two major issues in their respective Motions for Summary Judgment:

A. Whether a defective deed of trust provided constructive notice and/or inquiry notice of the Bank's purported lien on the Property to the Trustee — as a hypothetical lien creditor — so as to trump the Trustee's avoidance powers under 11 U.S.C. § 544.

B. Whether this Court, by equity, should validate a purported security interest in real property where the instrument granting the security interest — a deed of trust — is executed by an entity that does not own the property.

Ms. Moreno was the manager of Hotel Frisco, LLC, which owned and operated the business known as The Hotel Frisco, located in Frisco, Colorado. Ms. Moreno, individually, also owned certain adjacent real property consisting of vacant lots ("Property").

On December 1, 1999, Hotel Frisco and Ms. Moreno executed and delivered a promissory note ("Note") payable to the Bank in the original principal amount of $140,700.00. The caption on the Note provides that the "Borrower" is/are "HOTEL FRISCO, LLC (TIN: XXXXXXXXX); ET AL." The first paragraph of the Note defines the "Borrower" as Hotel Frisco, LLC and Louise C. Moreno. On the second page of the Note, there are two signatory lines: one for Hotel Frisco — with Louise Moreno as Manager of Hotel Frisco — and one for Ms. Moreno, in her individual capacity, and as co-borrower on the Note. The Note is signed, in the two spaces provided, by Ms. Moreno, individually, and as manager of Hotel Frisco.

Repayment of the Note was to be secured by a December 1, 1999 Deed of Trust ("Deed of Trust") which was intended to encumber the Property. The first page of the Deed of Trust sets forth that it is between the Bank and Hotel Frisco. On the final signatory page of the Deed of Trust, however, the "Grantor" is identified as Hotel Frisco "by Louise C. Moreno, Manager" and the Deed of Trust is signed by Ms. Moreno. That is: although Ms. Moreno owned the Property personally, Ms. Moreno signed the Deed of Trust in her capacity as manager for Hotel Frisco, only, and not in her individual capacity. Moreover, there is no signatory line for Ms. Moreno, in her individual capacity and as co-grantor on the Note and Deed of Trust. Further, the Deed of Trust simply defines the "Grantor" as "any and all persons and entities executing this deed of trust, including without limitation HOTEL FRISCO, L.L.C., A COLORADO LIMITED LIABILITY COMPANY." In the entire "Definitions" section of the Deed of Trust, specific reference is only made to Hotel Frisco.

The Deed of Trust was thereafter recorded in the Summit County real estate records.

On January 18, 2001, Ms. Moreno and Hotel Frisco filed separate Chapter 11 bankruptcy cases. Trustee was appointed to be the Chapter 7 Trustee in both cases.

On April 25, 2002, the Bankruptcy Judge entered an Order approving the sale of the Property [and reserving] for resolution at a later date (1) all disputes regarding liens and interests in the Property, including disputes regarding validity, priority, and extent of such liens or interests, and (2) allocation of the purchase price between estates.

On April 30, 2002, the Bank filed the within adversary proceeding seeking [a declaration] that the Trustee may not avoid the Deed of Trust pursuant to 11 U.S.C. § 544. Moreover, the Bank seeks a declaratory judgment that the Bank's Deed of Trust constitutes a valid and perfected lien upon the Property, junior only to the first lien held by First Commercial.

A. **Trustee's Avoidance Powers under 11 U.S.C. § 544**

The Trustee is seeking to avoid the lien created by the Deed of Trust under 11 U.S.C. § 544(a). As part of the legal fiction created, is the reality that despite any actual knowledge the trustee or the debtor has at the time of the bankruptcy filing, no such actual knowledge will be imputed to the trustee in his or her pursuit in avoiding claims under 11 U.S.C. § 544.

B. **There is No Constructive and/or Inquiry Notice of the Bank's Purported Lien on the Property**

The extent of the trustee's rights under 11 U.S.C. § 544 is measured by the substantive law of the jurisdiction governing the property in question. The Bank asserts that under applicable Colorado state law, the trustee's avoidance powers under 11 U.S.C. § 544 are subject to constructive notice and/or inquiry notice. Here, the Bank contends that under the circumstances, such constructive notice and/or inquiry notice precludes the Trustee from avoiding its admittedly defective lien on the property.

A proper execution and recording of the Deed of Trust would have placed the Trustee on constructive notice of the interest affecting title. Here, however, the Deed of Trust is not properly executed and does not create the intended security interest and, moreover, does not create an adequate record in the chain of title. Moreover, this Court believes that in light of the defect in the execution in the Deed of Trust, there are not sufficient facts that were discovered to "excite the attention" of a title searcher and place the Trustee on inquiry notice. In *In re Bandell Inv., Ltd.*, Judge Kane noted that the key to determining whether a trustee may use his strong arm avoiding powers under § 544(a) is whether, as a hypothetical purchaser at the time of the filing of the bankruptcy, he should be imputed with constructive notice of a deed of trust "as recorded in the appropriate fashion." 80 B.R. 210, 212 (D. Colo. 1987). In this case, the Trustee, conducting a title investigation, as a hypothetical prospective purchaser, would find, with respect to the property in question, only a transaction between Hotel Frisco, LLC and Alpine Bank. Ms. Moreno, individually, would not appear in the grantor/grantee indices in connection with the property. Therefore, no constructive notice can be imputed to the Trustee. A transaction conveying an interest — any interest — in the subject property from Ms. Moreno to Alpine Bank simply would not — and did not — appear in the chain of title, even if the Deed of Trust was "properly recorded."

C. **No Equitable Reason Exists to Allow the Deed of Trust to Create a Valid Security Interest in the Property**

The Bank admits it made a mistake. Thus, the Bank, as a banking institution, presumably with some experience in the area of securing loans, is "properly charged with the responsibility for compliance with applicable statutes." Id. at 852. It would seem with some minimal due diligence, the Bank could have properly prepared the paperwork to perfect its lien. Moreover, any conveyance interest in real property must be signed by the party making that conveyance. It is clear that Colorado law intends to mandate that only the owner of real property can encumber or convey the same. Here, while Ms. Moreno did sign the Deed of Trust, she did not sign it in her individual capacity. Instead, she signed only for Hotel Frisco in her capacity as manager of Hotel Frisco. Here, the Deed of Trust simply did not pass muster out of the gate. The Deed of Trust, made by the non-owner Hotel Frisco, not the owner, Ms. Moreno, is outside of the chain of title via the grantor-grantee indices. In addition, as noted above, no equitable grounds exist for validating this defective deed of trust. As a consequence, the Court will permit the Trustee to avoid the purported lien of the Bank pursuant to 11 U.S.C. § 544 for the benefit of the estate.

8.7. Preferences – 11 U.S.C. § 547

Equal distribution to similarly situated creditors is a cornerstone of the bankruptcy process. The preference law was designed to prevent the debtor from favoring certain creditors over others shortly before bankruptcy by allowing the trustee to recover the preferential transfer, restoring the creditor's claim, and thereby permitting equality of distribution.

Because of the difficulty of proving intent, the preference law was never limited to intentional preferences. And there is no particular logic to the preference time periods. Congress picked a bright line period (generally 90 days before bankruptcy), and provided that creditors who received a preferential benefit during that period must give it back and accept equality of treatment with other similarly situated creditors.

Despite its logic and fairness, the preference law has always been hated by creditors, and they have successfully lobbied Congress for greater and greater protections from it. Once the most powerful of the trustee's avoiding powers, Congress has created so many exceptions to the law that it is now more holes than cheese. Further, while the preference law was designed as a technical statute without regard to the debtor's or creditor's state of mind, the propriety of creditor conduct has become central to some of these exceptions. We start by understanding the definition of a preference, then look at an important common law exception, and then focus on the holes in the cheese created by the statutory exceptions.

8.8. Practice Problems: The Preference Law

Are the following transactions avoidable as preferences under Section 547(b)? Do not consider any preference exceptions or who may be liable for the recovery.

Problem 1. 10 days before bankruptcy, Debtor deeded his house to his mother for no consideration.

Problem 2. 10 days before bankruptcy, Debtor deeded his house to his mother in full satisfaction of a loan made to him a year earlier. The loan was in the amount of $100,000, and the house had a fair market value of $300,000, but was subject to a $225,000 first mortgage.

Problem 3. Same facts as Problem (2), except that Debtor gave the deed to his mother, and she recorded it, 91 days before Debtor filed bankruptcy.

Problem 4. Same facts as in Problem (2), except that the mother's loan was secured by a mortgage against the house properly recorded when the loan was made.

Problem 5. 91 days before bankruptcy, Debtor deeded his house to Bank of America in full satisfaction of a loan made to him a year earlier. The loan was in the amount of $100,000. The house had a fair market value of $300,000, but was subject to a $200,000 first mortgage.

Problem 6. Same facts as in Problem (5), but in addition Debtor's mother had guaranteed the Bank of America loan.

Problem 7. 89 days before bankruptcy, Bank of America foreclosed a mortgage held against Debtor's house. The mortgage secured a debt of $200,000 on a house the Debtor believes

was worth $250,000. Bank of America bought the house with a credit bid of $200,000 at the foreclosure sale.

Problem 8. Debtor made credit card payments of $1,000 on the 15th of every month, and filed bankruptcy on April 16th.

Problem 9. Credit card judgment creditor garnished $300 of the debtor's wages on the first and 15th of every month. Debtor filed bankruptcy on April 16.

Problem 10. Debtor borrowed $100,000 from Bank 100 days before bankruptcy. Debtor signed a promissory note and security agreement covering Debtor's business equipment before the loan was made. Bank filed a UCC-1 financing statement with the Secretary of State 21 days after the loan was made. *See* 11 U.S.C. § 547(e)(2).

Problem 11. Debtor repaid the loan in Problem (10) 10 days before bankruptcy. The equipment was worth $250,000.

Problem 12. Same facts as Problem (11) except that the equipment was worth $75,000.

Problem 13. Same facts as in Problem (12) except that instead of paying off the loan, Debtor made two $10,000 payments to the bank during the 90 day preference period.

Problem 14. Same facts as Problem (11) except Bank filed the UCC-1 financing statement with the secretary of state 31 days after the loan was made.

Problem 16. Same facts as Problem (11) except that Bank did not file a UCC-1 financing statement before bankruptcy.

Problem 17. Debtor's pizza parlor was having financial problems. Debtor owed his long-time sausage supplier $20,000, and more than $300,000 to other creditors. On January 1, Debtor gave his sausage supplier a security interest in his equipment to secure the debt, which was perfected within 30 days. The Debtor was insolvent at the time the security interest was given. Debtor filed bankruptcy on March 2. Can the trustee avoid the security interest?

Problem 18. What if Debtor in Problem (17) filed bankruptcy on April 4?

Problem 19. Debtor wrote a check 91 days before bankruptcy to pay an unsecured creditor's claim. Creditor cashed the check 90 days before bankruptcy, and Debtor's bank processed the check 88 days before bankruptcy. Is the payment preferential? *Barnhill v. Johnson*, 503 US 393 (1992) (because of debtor's ability to stop payment, transfer by check "takes effect" within the meaning of section 547Ie)(2) when check is honored by debtor's bank).

Problem 20. On the eve of bankruptcy, Debtor paid $150,000 cash for a new house. The transfer of title was recorded immediately. Can the trustee in bankruptcy avoid the $150,000 transfer and recover the cash? What if the house had a fair market value of only $75,000?

Problem 21. 10 days prior to filing bankruptcy, Debtor received a tax refund and used the proceeds to pay off a $10,000 loan to Debtor's mother. If Debtor had not paid his mother before bankruptcy, Debtor would have been able to exempt the full $10,000 tax refund under the "wild card" exemption. Nevertheless, the trustee seeks to avoid the $10,000 payment to Debtor's mother as a preferential transfer. Should the trustee win? Answer this question after you have read the Supreme Court's decision in *Beigier* below.

8.9. Cases on Preferences

8.9.1. BEIGIER v. IRS, 496 U.S. 53 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

American International Airways, Inc. (AIA), was a commercial airline. As an employer, AIA was required to withhold federal income taxes and to collect Federal Insurance Contributions Act (FICA) taxes from its employees' wages. As an airline, it was required to collect excise taxes from its customers for payment to the IRS. Because the amount of these taxes is "held to be a special fund in trust for the United States," they are often called "trust-fund taxes." By early 1984, AIA had fallen behind in its payments of its trust-fund taxes to the Government. In February of that year, the IRS ordered AIA to deposit all trust-fund taxes it collected thereafter into a separate bank account. AIA established the account, but did not deposit funds sufficient to cover the entire amount of its trust-fund tax obligations. It nonetheless remained current on these obligations through June 1984, paying the IRS $695,000 from the separate bank account and $946,434 from its general operating funds. AIA and the IRS agreed that all of these payments would be allocated to specific trust-fund tax obligations.

On July 19, 1984, AIA [filed] under Chapter 11. On September 19, the Bankruptcy Court appointed petitioner Harry P. Begier, Jr., trustee, and a plan of liquidation in Chapter 11 was confirmed. Seeking to exercise his avoidance power, Begier filed an adversary action against the Government to recover the entire amount that AIA had paid the IRS for trust-fund taxes during the 90 days before the bankruptcy filing.

Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property. Section 547(b) furthers this policy by permitting a trustee in bankruptcy to avoid certain preferential payments made before the debtor files for bankruptcy. This mechanism prevents the debtor from favoring one creditor over others by transferring property shortly before filing for bankruptcy. Of course, if the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated. The reach of 547(b)'s avoidance power is therefore limited to transfers of "property of the debtor."

The Bankruptcy Code does not define "property of the debtor." Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate - the property available for distribution to creditors - "property of the debtor" subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings. For guidance, then, we must turn to 541, which delineates the scope of "property of the estate" and serves as the postpetition analog to 547(b)'s "property of the debtor."

Section 541(d) provides: "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is

not "property of the estate." Nor is such an equitable interest "property of the debtor" for purposes of 547(b). As the parties agree, then, the issue in this case is whether the money AIA transferred from its general operating accounts to the IRS was property that AIA had held in trust for the IRS.

We begin with the language of 26 U.S.C. 7501, the Internal Revenue Code's trust-fund tax provision: "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." The statutory trust extends, then, only to "the amount of tax so collected or withheld." Begier argues that a trust-fund tax is not "collected or withheld" until specific funds are either sent to the IRS with the relevant return or placed in a segregated fund. AIA neither put the funds paid from its general operating accounts in a separate account nor paid them to the IRS before the beginning of the preference period. Begier therefore contends that no trust was ever created with respect to those funds and that the funds paid to the IRS were therefore property of the debtor.

We disagree. The Internal Revenue Code directs "every person receiving any payment for facilities or services" subject to excise taxes to "collect the amount of the tax from the person making such payment." It also requires that an employer "collec[t]" FICA taxes from its employees "by deducting the amount of the tax from the wages as and when paid." Both provisions make clear that the act of "collecting" occurs at the time of payment - the recipient's payment for the service in the case of excise taxes and the employer's payment of wages in the case of FICA taxes. The mere fact that AIA neither placed the taxes it collected in a segregated fund nor paid them to the IRS does not somehow mean that AIA never collected the taxes in the first place.

The same analysis applies to taxes the Internal Revenue Code requires that employers "withhold." Section 3402(a) (1) requires that "every employer making payment of wages shall deduct and withhold upon such wages [the employee's federal income tax]." (Emphasis added.) Withholding thus occurs at the time of payment to the employee of his net wages.

We conclude, therefore, that AIA created a trust within the meaning of 7501 at the moment the relevant payments (from customers to AIA for excise taxes and from AIA to its employees for FICA and income taxes) were made.

Our holding that a trust for the benefit of the IRS existed is not alone sufficient to answer the question presented by this case: whether the particular dollars that AIA paid to the IRS from its general operating accounts were "property of the debtor." Only if those particular funds were held in trust for the IRS do they escape characterization as "property of the debtor." [the Court then reviews the legislative history of the bankruptcy Code.] The House Report . . . states:

> A payment of withholding taxes constitutes a payment of money held in trust under Internal Revenue Code 7501(a), and thus will not be a preference because the beneficiary of the trust, the taxing authority, is in a separate class with respect to those taxes, if they have been properly held for payment, as they will have been if the debtor is able to make the payments."

H. R. Rep. No. 95-595, supra, at 373. Under a literal reading of the above passage, the bankruptcy trustee could not avoid any voluntary prepetition payment of trust-fund taxes, regardless of the source of the funds. As the House Report expressly states, the limitation that the funds must "have been properly held for payment" is satisfied "if the debtor is able to make the

payments." The debtor's act of voluntarily paying its trust-fund tax obligation therefore is alone sufficient to establish the required nexus between the "amount" held in trust and the funds paid.

We adopt this literal reading. In the absence of any suggestion in the Bankruptcy Code about what tracing rules to apply, we are relegated to the legislative history. The courts are directed to apply "reasonable assumptions" to govern the tracing of funds, and the House Report identifies one such assumption to be that any voluntary prepetition payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property. Nothing in the Bankruptcy Code or its legislative history casts doubt on the reasonableness of that assumption. Other rules might be reasonable, too, but the only evidence we have suggests that Congress preferred this one. We see no reason to disregard that evidence. We hold that AIA's payments of trust-fund taxes to the IRS from its general accounts were not transfers of "property of the debtor," but were instead transfers of property held in trust for the Government pursuant to 7501. Such payments therefore cannot be avoided as preferences.

8.9.2. IN RE CASTILLO, 39 B.R. 45 (Bankr. D. Col. 1984)

This matter comes before the Court upon the Trustee's Complaint for Avoidance of a Preferential Transfer and for Turnover.

The Debtors contracted for, and obtained, the services of the Defendant, Rivera Funeral Home (Rivera). The Debtors executed a note for $2,306.00 in favor of Rivera and paid this amount down until June 29, 1983, at which time there was a balance due of $1,463.25. Rivera then demanded payment of the balance.

The Debtors went to Minnequa Bank on June 29, 1983, and borrowed that amount. The Debtors executed a note for principal and interest in favor of the Bank for $1,733.28. Rivera cosigned this note and also signed a guaranty agreement. The Bank drew a check to the order of Rivera on the same day, June 29, 1983.

The Debtors filed their voluntary Chapter 7 petition on September 12, 1983. When the Bank received notice of the Debtors' bankruptcy, they called on the guarantor and co-signer, Rivera, to pay off the note. Rivera paid the Bank $1,462.07.

The Trustee claims that the initial payment by the Bank to Rivera was a preferential transfer since all the elements of section 547(b) of the Bankruptcy Code have been satisfied.

The first element of a preferential transfer as set forth in section 547(b) requires that there be a transfer of property of the debtor. As a general rule, when a third person makes a loan to the debtor specifically to enable him to satisfy the claim of a designated creditor, the proceeds never become part of the debtor's assets, and therefore, no preference is created. The rule is the same regardless of whether the proceeds of the loan are transferred directly by the lender to the creditor or are paid to the debtor with the understanding that they will be paid to the creditor in satisfaction of his claim, so long as such proceeds are clearly "earmarked." Because there has been no transfer of the debtor's property, there has been no diminution of the debtor's estate, and consequently, there has been no preference.

In this case, it is undisputed that the Bank made Rivera the sole payee on the check. The debtor had no control over the use or disposition of the funds. The money was never available to satisfy the claims of general creditors. There was nothing more than a substitution of one creditor for another and no diminution of the debtor's estate resulted. Consequently, the Trustee's attempt to void the transfer by the Bank to Rivera falters at the very start, as there was no transfer of the Debtor's property or diminution of the estate.

8.9.3. PARKS v. FIA CREDIT SERVICES, N.A., 550 F.3d 1251 (10th Cir. 2008)

Debtors had two credit card accounts with MBNA. They also had two credit card accounts with Capital One. On July 27, 2005, Debtors directed Capital One to pay MBNA $17,000 on the first MBNA account through a balance transfer from their first Capital One account. On the same day, they directed Capital One to pay MBNA $21,000 on the second MBNA account through a balance transfer from their second Capital One account.

On October 13, 2005, Debtors filed a bankruptcy petition under Chapter 7 of the Bankruptcy Code. Parks was appointed Trustee. Because Debtors' payments to MBNA were made within ninety days of the filing of the bankruptcy petition (referred to as the preference period), Parks filed an adversary complaint against MBNA seeking to avoid these payments as preferential transfers.

The bankruptcy court determined Debtors' payments to MBNA were not preferential transfers because they did not constitute transfers of an interest of Debtors in property as required by 11 U.S.C. § 547(b):

> [T]he funds paid to . . . MBNA were assets of Capital One in which the Debtors did not have an interest for purposes of § 547. Debtors merely exercised an offer to transfer credit card balances; this offer, if not exercised as of the date of filing, would have added no value to the estate. The transfer was a mere substitution of creditors which had no impact on either the property of the estate or the value of the claims asserted against the estate.

Parks appealed to the district court, [which] affirmed but analyzed the case under the earmarking doctrine which, in its broadest terms, exempts a debtor's use of borrowed funds from the Trustee's avoidance powers when those funds are lent for the purpose of paying a specific debt. In doing so, it looked to the amount of control Debtors exercised over the payments to MBNA and whether the transfer of those payments diminished the bankruptcy estate. It thought Debtors lacked the requisite control over the payments for them to constitute interests of Debtors in property:

> It is undisputed that the debtors never possessed a check or proceeds of a loan. Capital One was under no obligation to cooperate with the debtors' request. The debtor[s] could not compel Capital One to make a payment. Nonetheless, Capital One chose to make a payment directly and specifically to MBNA on the debtors' behalf and essentially substituted itself as the debtors' creditor for the MBNA

> debt under the terms agreed [to] through the balance transfer agreement. The Court finds this to be a bank to bank transfer resulting in a substitution of the debtors' creditors.

The district court also concluded that because there was never a transfer of assets, only credit, the bankruptcy estate was not diminished.

The purpose of the [preference] statute is two-fold: (1) "to secure an equal distribution of assets among creditors of like class" and (2) "to discourage actions by creditors that might prematurely compel the filing of a [bankruptcy] petition."

Only the threshold requirement of 11 U.S.C. § 574(b) is at issue here, i.e., whether the payments made to Debtors' MBNA credit card accounts from their Capital One credit card accounts constitute transfers of "an interest of the debtor in property."

The Bankruptcy Code does not define "an interest of the debtor in property." However, in *Begier v. IRS*, the Supreme Court said:

> Because the purpose of the avoidance provision is to preserve the property includable within the bankruptcy estate—the property available for distribution to creditors—"property of the debtor" subject to the preferential transfer provision is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings. For guidance, then, we must turn to § 541, which delineates the scope of "property of the estate" and serves as the postpetition analog to § 547(b)'s "property of the debtor."

496 U.S. 53

Courts have used the dominion/control test to determine whether a transfer of property was a transfer of "an interest of the debtor in property." Under this test, a transfer of property will be a transfer of "an interest of the debtor in property" if the debtor exercised dominion or control over the transferred property.

Other courts have applied a diminution of the estate test. Under this analysis, a debtor's transfer of property constitutes a transfer of "an interest of the debtor in property" if it deprives the bankruptcy estate of resources which would otherwise have been used to satisfy the claims of creditors. "[I]f the debtor transfers property that would not have been available for distribution to his creditors in a bankruptcy proceeding, the policy behind the avoidance power is not implicated." *Begier*, 496 U.S. at 58.

As both the district court and bankruptcy court acknowledged, their conclusion that the credit card payments in this case were not transfers of "an interest of [Debtors] in property" represents the minority view. The majority of courts to address the issue have gone the other way. These courts reason that the debtor, even if never in actual possession of the loaned proceeds, exercises dominion or control over them as evidenced by an ability to direct their distribution. They also conclude such transactions deplete the bankruptcy estate—when a debtor converts an offer of credit into loan proceeds and uses those proceeds to pay another creditor, the debtor deprives the bankruptcy estate of those proceeds.

We agree with the majority view. Technology masks the processes involved here. Separating them into constituent elements reveals a sequence of events, not just one: Debtors drew on their Capital One line of credit; that draw converted available credit into a loan; Debtors directed Capital One to use the loan proceeds to pay MBNA; and Capital One complied. It is essentially the same as if Debtors had drawn on their Capital One line of credit, deposited the proceeds into an account within their control, and then wrote a check to MBNA. The latter is clearly a preference.

Contrary to the district court's conclusion, there is no evidence Capital One could have stopped the payments to MBNA once it honored Debtors' draw. The payments were a debtor's discretionary use of borrowed funds to pay another debt. Such transactions are generally considered preferential transfers. The only exception to this rule is the earmarking doctrine, which the district court incorrectly applied.

Earmarking, even if extended beyond the codebtor context, only applies when the lender **requires** the funds be used to pay a specific debt. Here, Capital One placed no conditions on Debtors' use of the funds, it only honored their instructions. The earmarking doctrine is inapplicable.

And Debtors' exercise of control of the loan proceeds also distinguishes this case from a bank-to-bank transfer of consumer debt, in which one bank simply agrees to purchase consumer debt from another bank. A debtor is not directly involved, let alone in control—a notice comes to the debtor redirecting required payments to the acquiring institution. Moreover, there was no agreement between Capital One and MBNA for the purchase of Debtors' paper.

We also consider whether Debtors' transfer of the Capital One loan proceeds to MBNA diminished the bankruptcy estate. It did. The net value of the estate did not change because the Capital One infusion of loan proceeds was totally offset by additional debt to Capital One. But that is not the relevant test. We must ask whether the loan proceeds "would have been part of the estate had [they] not been transferred before the commencement of bankruptcy proceedings." The Capital One loan proceeds were an asset of the estate **for at least an instant** before they were preferentially transferred to MBNA. The preferential transfer look back is not time sensitive—the issue is whether any asset, regardless of how fleeting its presence in the bankrupt's estate during the relevant period of time, should be ratably apportioned among qualified creditors or permitted to benefit only a preferred creditor. The answer is as clear as the statute itself—all preferential transfers of estate assets during the ninety-day look back are subject to recapture.

In reaching the opposite conclusion, the district court and bankruptcy court mistakenly characterized the transferred property as untapped credit. In their view untapped credit cannot be used to satisfy creditors and, thus, no diminution of the estate occurred. But this case does not involve untapped credit. A transfer of loan proceeds (an asset) diminishes the bankrupt's estate.

Treating the payments to MBNA as avoidable preferential transfers furthers § 547(b)'s policy of equality of distribution between similarly situated creditors. Recapture allows all qualifying creditors, including Capital One and FIA, to ratably share in a $38,000 estate asset.

8.9.4. IN RE UNICOM COMPUTER CORPORATION, 13 F.3d 321 (9th Cir. 1994)

In this appeal we are called upon to decide whether a debtor's prepetition transfer to a creditor of money belonging to the creditor but mistakenly received by the debtor constitutes a voidable preference because the debtor had temporary possession of the money within ninety days of the filing of its petition in bankruptcy. The Bankruptcy Appellate Panel ("BAP") upheld the bankruptcy court's ruling that, for purposes of bankruptcy law, the debtor's prepetition transfer of the payment to its rightful owner constituted a voidable preference. We reverse.

Acting as a computer equipment broker on behalf of its client, Pitney Bowes, Inc. ("Pitney"), Unicom Computer Corporation ("Unicom") arranged a computer equipment lease in early 1983 between Pitney and Mitsui Manufacturers Bank ("Mitsui"). Under the terms of the agreement worked out by Unicom, Mitsui purchased computer equipment, and then leased the equipment to Pitney for five years at a monthly rental of $44,197. Pitney made its monthly lease payments directly to [Mitsui]

Midway through the lease term, Pitney told Unicom that it wanted to get out of the five-year lease. Although unable to locate a party willing to step into Pitney's shoes and re-lease the equipment at the $44,197 monthly rental figure, Unicom did find a company, Cincinnati Milacron ("Cinci"), willing to sublease it for two years at a substantially reduced rent. Pursuant to a deal worked out by Unicom, Pitney consented to sublet the equipment directly to Unicom for twenty-four months at a monthly rental of $20,000. Unicom in turn sub-sublet the equipment to Cinci for the same time period (i.e., between January 1986 and December 1987) at a monthly rental of $22,000.

Unicom failed to bill Pitney for the final two payments until late April 1988, nearly two months after the five-year lease term had expired. Unicom then compounded its error by instructing Pitney to send its payment to Unicom instead of to Mitsui. As a final complication, Unicom did not forward Pitney's check to Mitsui but deposited it to its own (i.e., Unicom's) account.

Unicom corrected its mistake in August 1988 by remitting the full amount of Pitney's misdirected payment to Mitsui; the following month, Unicom filed a Chapter 11 petition in bankruptcy.

Nearly two years later Unicom filed the instant adversary proceeding against Mitsui, arguing that its August 1988 payment constituted a voidable preference because it had been made within ninety days of the bankruptcy petition's filing. Mitsui countered by arguing that the payment could not be viewed as a preference, voidable or otherwise, because the money was never Unicom's property, i.e., Unicom never had any right to the money and was merely holding it in constructive trust for Mitsui.

The bankruptcy court rejected Mitsui's argument, and the BAP affirmed in a 2-1 decision, holding that, while a constructive trust would ordinarily arise under California law in favor of Mitsui, Mitsui had failed to prove that the equities involved mandated such a result under federal bankruptcy law. Judge Russell said in dissent that, once Mitsui had established its right to the money, the burden of proof shifted to Unicom as the debtor-in-possession to prove that it would

be inequitable to impose a constructive trust over the funds belonging to Mitsui. Mitsui has timely appealed.

Although the parties have asserted at least three issues on appeal, this case stands or falls on the answer to one question: Does the fact that Unicom acquired temporary possession of Pitney's final lease payment to Mitsui render that payment Unicom's property for bankruptcy purposes? For the reasons which follow, we conclude that it does not.

One of the ways in which federal bankruptcy law seeks to equalize the positions of similarly situated creditors is by giving trustees in bankruptcy the power to set aside so-called preferential transfers of a debtor's property. Thus, a trustee may ordinarily avoid a transfer of a debtor's interest in property made to a creditor on account of an antecedent debt if that transfer occurred within ninety days of the date of the filing of the debtor's bankruptcy petition. 11 U.S.C. Sec. 547(b). Put another way, a transfer may be avoided under section 547(b) if it involves property of the debtor and the transfer reduces the amount of the bankruptcy estate available for the payment of other creditors.

The key, of course, lies with the correct definition of "property". In its simplest terms, property of the debtor may be said to be that which would have been property of the bankruptcy estate had the transfer not taken place. The relevant statute broadly--and somewhat unhelpfully--defines property of a debtor's estate as including "all legal or equitable interests of the debtor in property". 11 U.S.C. Sec. 541(a)(1). However, it does not include "any power that the debtor may exercise solely for the benefit" of another, 11 U.S.C. Sec. 541(b)(1), nor does it include "[p]roperty in which the debtor holds ... only legal title and not an equitable interest". 11 U.S.C. Sec. 541(d). Thus, something held in trust by a debtor for another is neither property of the bankruptcy estate under section 541(d), nor property of the debtor for purposes of section 547(b).

In the instant case, of course, we are dealing with a particular type of trust, viz., a constructive trust that allegedly arose by operation of state law. Although we have never expressly held that the same rule (viz., funds held in trust are property neither of the debtor nor of the bankruptcy estate) should apply as well to situations involving funds held by a debtor in constructive trust, the rule would seem to apply with equal force to both situations.

Situations occasionally arise where property ostensibly belonging to the debtor will actually not be property of the debtor, but will be held in trust for another. For example, if the debtor has incurred medical bills that were covered by insurance, and the insurance company had sent the payment of the bills to the debtor before the debtor had paid the bill for which the payment was reimbursement, the payment would actually be held in a constructive trust for the person to whom the bill was owed.

Unicom never had any right to accept Pitney's check on behalf of Mitsui. Moreover, California law differs from Arizona law in that, while the latter recognizes only active misconduct as a ground for imposing a constructive trust in favor of creditors, California law provides for the imposition of a constructive trust in a situation involving simple negligence on the part of a debtor who wrongfully detains another's property.

It cannot be denied that the money represented by Pitney's misdirected check belonged to Mitsui, not Unicom. Moreover, it is clear that Unicom, having wrongfully and by virtue of its own mistake(s) acquired and retained funds properly belonging to Mitsui, had at most only a bare legal title to those funds. Once Mitsui had established as a matter of state law that grounds properly

existed for imposing a constructive trust over those funds, it was up to Unicom as the debtor-in-possession to prove that it would be inequitable as a matter of federal bankruptcy law to impose a constructive trust over those funds. This Unicom has failed to do. Because we find nothing that would warrant overriding the dictates of California law in favor of some unspecified, overarching principle(s) of federal bankruptcy law, we hold that a constructive trust in favor of Mitsui arose over the funds represented by Pitney's misdirected check.

8.10. Preference Defenses – 11 U.S.C. § 547(c)

Section 547(c) of the Bankruptcy Code now contains nine statutory defenses to preference actions. Each will be discussed in order.

First is the **contemporaneous exchange for new value** defense. 11 U.S.C. § 547(c)(1). This defense relates to the basic statutory requirement that the payment be made to a creditor (on account of an antecedent debt). A purchase (contemporaneous exchange) does not involve a preferential payment to a creditor, and the result should not depend on whether the seller or the buyer tendered first. If the parties intended a contemporaneous sale and not a credit transaction, and the resulting transaction was "substantially" contemporaneous, the preference law should not apply.

Second is the ordinary course payment. 11 U.S.C. § 547(c)(2). This was a very limited exception when the Bankruptcy Code was originally enacted, covering only payments made within 45 days after the debt was incurred. For many years, the payment had to be made both according to the ordinary course of business between the parties AND according to ordinary business terms. Read Judge Posner's opinion in *Tolana Pizza*, below, which was decided when **both** Section 547(c)(2)(A) and Section 547(c)(2)(B) had to be met. Now, the payment need only be made according to ordinary terms between the parties OR according to ordinary industry terms. If Judge Posner's liberal test of ordinariness is going to be applied, only a very unusual payment will be trip the statute.

Third is a special defense for purchase money security interests in Section 547(c)(3) of the Bankruptcy Code, that will only rarely be needed by creditors. At one time, regular security interests had to be perfected within 10 days of attachment for the perfection not to be treated as the relevant transfer for preference purposes under 547(e)(2). Originally, purchase money security interests got a longer 20 day period. With the expansion of the 547(e)(2) relation-back period to 30 days for all security interests, the purchase money exception will only rarely be needed. Because the 30 day period in Section 547(c)(3) for purchase money security interests runs from the date the debtor receives possession of the collateral, rather than from the date of attachment under 547(e)(2), the defense will help the purchase money secured creditor by providing a longer relation-back period when the debtor received possession of the collateral after the date that the lien attached.

Fourth is the new value exception. 11 U.S.C. § 547(c)(4). If, after the creditor receives a preferential payment, the creditor gives new value to the estate the preference is reduced by the new value because the harm to the estate from the preference is reduced by the benefit to the estate of the new value. Timing is everything under this rule. Only new value given AFTER the receipt of a preferential transfer reduces the preference. New value given during the preference period but

BEFORE the preferential payment does not reduce the preference. You cannot simply add up the preferential transfers and new value – you must consider timing. The question is, "was the new value given **after** the preferential transfer?" If the new value was given before, rather than after, the preferential transfer, the new value would not reduce the amount of the preference.

Fifth is the so-called "reduction in insufficiency" test that applies to floating liens on inventory and receivables. 11 U.S.C. § 547(c)(5). This test is very hard to understand on a first reading, but is easily mastered. A creditor's "insufficiency" is the balance that would be owing to the creditor if the collateral were sold and the proceeds paid to the lender. It is the excess of the debt over the value of the collateral, what is normally called the "deficiency." If a creditor's $100 loan is secured by $40 of collateral, the creditor has a $60 insufficiency. If during the preference period the creditor's insufficiency is reduced (say from $60 to $50), one of two things must have happened: either the debtor paid down the loan or purchased some additional collateral – either way, the debtor paid money that would otherwise have gone to unsecured creditors to reduce the secured creditor's insufficiency.[2]

The test measures the insufficiency at only two points in time: (1) the beginning of the preference period (or if the loan was first made during the preference period, the date the loan was made) and (2) the bankruptcy filing date. This limits the creditor's liability for the payment made by the debtor to the creditor and purchases of additional collateral during the preference period to those that had a net benefit to the creditor during the entire period. If the insufficiency between the beginning and end of the preference period was not reduced, the purchase of additional inventory and the loan payments made during the preference period would not be avoidable as preferences.

Sixth are exceptions for statutory liens. Statutory liens are governed by Section 545, which validates true statutory liens but invalidates certain statutory liens that are designed to give priority to creditors only in bankruptcy 11 U.S.C. § 547(c)(6).

Seventh, newly enacted in 2005, this exception gives a "get-out-of-preference-liability" card to domestic support creditors. 11 U.S.C. § 547(c)(7).

Eighth and Ninth are new floors enacted in 2005 which eliminate most consumer and small business preferences. 11 U.S.C. § 547(c)(8), (c)(9). Preferential payments by **consumer debtors** of **less than $600** to any one creditor are no longer avoidable. Preferential payments by businesses (non-consumers) of **less than $5,850** to any one creditor are not avoidable. Note that if a debtor paid $1 over these floor amounts, the full transfer is avoidable as a preference. Only relatively large transfers are now subject to preference attack.

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[2] Ok, technically there is another possibility. It is theoretically possible for the inventory or receivables to increase in value even though the estate did not purchase additional inventory or generate new receivables. For example, a gold bullion dealer's inventory could go up in value with the rise in the price of gold without any contribution by the estate. In this case, the increase in the value of the collateral would not result from a transfer of property, and there would be no underlying preference. A gold bullion dealer would not need a preference exception to keep the increase in the value of the bullion as long as the estate made no transfer of additional collateral to the creditor.

8.11. Cases on Preference Defenses

8.11.1. UNION BANK v. WOLAS, 502 U.S. 151 (1991)

JUSTICE STEVENS delivered the opinion of the Court.

Section 547(b) of the Bankruptcy Code, 11 U.S.C. 547(b), authorizes a trustee to avoid certain property transfers made by a debtor within 90 days before bankruptcy. The Code makes an exception, however, for transfers made in the ordinary course of business, 11 U.S.C. 547(c)(2). The question presented is whether payments on long-term debt may qualify for that exception.

On December 17, 1986, ZZZZ Best Co., Inc. (Debtor) borrowed seven million dollars from petitioner, Union Bank (Bank). On July 8, 1987, the Debtor filed a voluntary petition under Chapter 7 of the Bankruptcy Code. During the preceding 90-day period, the Debtor had made two interest payments totaling approximately $100,000, and had paid a loan commitment fee of about $2,500 to the Bank. After his appointment as trustee of the Debtor's estate, respondent filed a complaint against the Bank to recover those payments pursuant to 547(b).

The Bankruptcy Court found that the loans had been made "in the ordinary course of business or financial affairs" of both the Debtor and the Bank, and that both interest payments, as well as the payment of the loan commitment fee, had been made according to ordinary business terms and in the ordinary course of business. As a matter of law, the Bankruptcy Court concluded that the payments satisfied the requirements of 547(c)(2), and therefore were not avoidable by the trustee. The District Court affirmed.

Shortly thereafter, in another case, the Court of Appeals held that the ordinary course of business exception to avoidance of preferential transfers was not available to long-term creditors. In reaching that conclusion, the Court of Appeals relied primarily on the policies underlying the voidable preference provisions and the state of the law prior to the enactment of the 1978 Bankruptcy Code and its amendment in 1984.

The text provides no support for respondent's contention that 547(c)(2)'s coverage is limited to short-term debt, such as commercial paper or trade debt. Given the clarity of the statutory text, respondent's burden of persuading us that Congress intended to create or to preserve a special rule for long-term debt is exceptionally heavy.

In sum, we hold that payments on long-term debt, as well as payments on short-term debt, may qualify for the ordinary course of business exception to the trustee's power to avoid preferential transfers. We express no opinion, however, on the question whether the Bankruptcy Court correctly concluded that the Debtor's payments of interest and the loan commitment fee qualify for the ordinary course of business exception, 547(c)(2). In particular, we do not decide whether the loan involved in this case was incurred in the ordinary course of the Debtor's business and of the Bank's business, whether the payments were made in the ordinary course of business, or whether the payments were made according to ordinary business terms. These questions remain open for the Court of Appeals on remand.

JUSTICE SCALIA, concurring.

I join the opinion of the Court, including Parts II and III, which respond persuasively to legislative history and policy arguments made by respondent. It is regrettable that we have a legal culture in which such arguments have to be addressed (and are indeed credited by a Court of Appeals), with respect to a statute utterly devoid of language that could remotely be thought to distinguish between long-term and short-term debt. Since there was here no contention of a "scrivener's error" producing an absurd result, the plain text of the statute should have made this litigation unnecessary and unmaintainable.

Author's Note. The 2005 amendments changed the relationship between and renumbered the provisions at issue in the following case. Prior to the 2005 amendments, current 547(c)(2)(A) and (B) were numbered as 547(c)(2)(B) and (C). More importantly, in 2005 Congress changed the word connecting the two provisions from "and" to "or." Consider the effect of this change in light of the decision below regarding the meaning of current 547(c)(2)(A).

8.11.2. IN RE TOLANA PIZZA, 3 F.3d 1029 (7th Cir. 1993)

POSNER, Circuit Judge.

When, within 90 days before declaring bankruptcy, the debtor makes a payment to an unsecured creditor, the payment is a "preference," and the trustee in bankruptcy can recover it and thus make the creditor take pot luck with the rest of the debtor's unsecured creditors. 11 U.S.C. Sec. 547. But there is an exception if the creditor can show that the debt had been incurred in the ordinary course of the business of both the debtor and the creditor, Sec. 547(c)(2)(A); that the payment, too, had been made and received in the ordinary course of their businesses, Sec. 547(c)(2)(B); and that the payment had been "made according to ordinary business terms." Sec. 547(c)(2)(C). The first two requirements are easy to understand: of course to defeat the inference of preferential treatment the debt must have been incurred in the ordinary course of business of both debtor and creditor and the payment on account of the debt must have been in the ordinary course as well. But what does the third requirement--that the payment have been "made according to ordinary business terms"--add? And in particular does it refer to what is "ordinary" between this debtor and this creditor, or what is ordinary in the market or industry in which they operate? The circuits are divided on this question

Tolona, a maker of pizza, issued eight checks to Rose, its sausage supplier, within 90 days before being thrown into bankruptcy by its creditors. The checks, which totaled a shade under $46,000, cleared and as a result Tolona's debts to Rose were paid in full. Tolona's other major trade creditors stand to receive only 13 cents on the dollar under the plan approved by the bankruptcy court, if the preferential treatment of Rose is allowed to stand. Tolona, as debtor in possession, brought an adversary proceeding against Rose to recover the eight payments as voidable preferences. The bankruptcy judge entered judgment for Tolona. The district judge reversed. He thought that Rose did not, in order to comply with section 547(c)(2)(C), have to prove that the terms on which it had extended credit to Tolona were standard terms in the industry, but that if this was wrong the testimony of Rose's executive vice-president, Stiehl, did prove it. The parties agree that the other requirements of section 547(c)(2) were satisfied.

Rose's invoices recited "net 7 days," meaning that payment was due within seven days. For years preceding the preference period, however, Tolona rarely paid within seven days; nor did Rose's other customers. Most paid within 21 days, and if they paid later than 28 or 30 days Rose would usually withhold future shipments until payment was received. Tolona, however, as an old and valued customer (Rose had been selling to it for fifteen years), was permitted to make payments beyond the 21-day period and even beyond the 28-day or 30-day period. The eight payments at issue were made between 12 and 32 days after Rose had invoiced Tolona, for an average of 22 days; but this actually was an improvement. In the 34 months before the preference period, the average time for which Rose's invoices to Tolona were outstanding was 26 days and the longest time was 46 days. Rose consistently treated Tolona with a degree of leniency that made Tolona (Stiehl conceded on cross-examination) one of a "sort of exceptional group of customers of Rose ... fall[ing] outside the common industry practice and standards."

It may seem odd that paying a debt late would ever be regarded as a preference to the creditor thus paid belatedly. But it is all relative. A debtor who has entered the preference period--who is therefore only 90 days, or fewer, away from plunging into bankruptcy--is typically unable to pay all his outstanding debts in full as they come due. If he pays one and not the others, as happened here, the payment though late is still a preference to that creditor, and is avoidable unless the conditions of section 547(c)(2) are met. One condition is that payment be in the ordinary course of both the debtor's and the creditor's business. A late payment normally will not be. It will therefore be an avoidable preference.

This is not a dryly syllogistic conclusion. The purpose of the preference statute is to prevent the debtor during his slide toward bankruptcy from trying to stave off the evil day by giving preferential treatment to his most importunate creditors, who may sometimes be those who have been waiting longest to be paid. Unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm's assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable.

From this standpoint, however, the most important thing is not that the dealings between the debtor and the allegedly favored creditor conform to some industry norm but that they conform to the norm established by the debtor and the creditor in the period before, preferably well before, the preference period. That condition is satisfied here--if anything, Rose treated Tolona more favorably (and hence Tolona treated Rose less preferentially) before the preference period than during it.

But if this is all that the third subsection of 547(c)(2) requires, it might seem to add nothing to the first two subsections, which require that both the debt and the payment be within the ordinary course of business of both the debtor and the creditor. For, provided these conditions are fulfilled, a "late" payment really isn't late if the parties have established a practice that deviates from the strict terms of their written contract. But we hesitate to conclude that the third subsection, requiring conformity to "ordinary business terms," has no function in the statute. We can think of two functions that it might have. One is evidentiary. If the debtor and creditor dealt on terms that the creditor testifies were normal for them but that are wholly unknown in the industry, this casts some doubt on his (self-serving) testimony. Preferences are disfavored, and subsection C makes them more difficult to prove. The second possible function of the subsection is to allay the concerns of creditors that one or more of their number may have worked out a special deal with the debtor,

before the preference period, designed to put that creditor ahead of the others in the event of bankruptcy. It may seem odd that allowing late payments from a debtor would be a way for a creditor to make himself more rather than less assured of repayment. But such a creditor does have an advantage during the preference period, because he can receive late payments then and they will still be in the ordinary course of business for him and his debtor.

The functions that we have identified, combined with a natural reluctance to cut out and throw away one-third of an important provision of the Bankruptcy Code, persuade us that the creditor must show that the payment he received was made in accordance with the ordinary business terms in the industry. But this does not mean that the creditor must establish the existence of some single, uniform set of business terms, as Tolona argues. Not only is it difficult to identify the industry whose norm shall govern (is it, here, the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?), but there can be great variance in billing practices within an industry. Apparently there is in this industry, whatever exactly "this industry" is; for while it is plain that neither Rose nor its competitors enforce payment within seven days, it is unclear that there is a standard outer limit of forbearance. It seems that 21 days is a goal but that payment as late as 30 days is generally tolerated and that for good customers even longer delays are allowed. The average period between Rose's invoice and Tolona's payment during the preference period was only 22 days, which seems well within the industry norm, whatever exactly it is. The law should not push businessmen to agree upon a single set of billing practices; antitrust objections to one side, the relevant business and financial considerations vary widely among firms on both the buying and the selling side of the market.

We conclude that "ordinary business terms" refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that **only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope** of subsection C. Stiehl's testimony brought the case within the scope of "ordinary business terms" as just defined. Rose and its competitors pay little or no attention to the terms stated on their invoices, allow most customers to take up to 30 days to pay, and allow certain favored customers to take even more time. There is no single set of terms on which the members of the industry have coalesced; instead there is a broad range and the district judge plausibly situated the dealings between Rose and Tolona within it. These dealings are conceded to have been within the normal course of dealings between the two firms, a course established long before the preference period, and there is no hint either that the dealings were designed to put Rose ahead of other creditors of Tolona or that other creditors of Tolona would have been surprised to learn that Rose had been so forbearing in its dealings with Tolona.

It is true that Stiehl testified that Tolona was one of an exceptional group of Rose's customers with whom Rose's dealings fell outside common industry practice. But the undisputed evidence concerning those dealings and the practices of the industry demonstrates that payment within 30 days is within the outer limits of normal industry practices, and the payments at issue in this case were made on average in a significantly shorter time.

8.12. Practice Problems: Preference Exceptions

Problem 1. Debtor was a stock broker. Debtor had to pay in cash for securities purchased during the day. In order to have the cash ready for purchases, it had a clearance line of credit with National City Bank. The debtor drew funds from the Bank during the day to pay for securities, and provided cash or securities to the Bank at the end of the day to cover the loan balance. At 10:00 a.m. on January 19, 1910, the Debtor's assets exceeded its liabilities by half a million dollars. At that time, National City made a $500,000 clearance line of credit available to the Debtor. Shortly before noon, the stock market crashed, and by noon the firm was suspended. Hearing of the crash, National City demanded that the Debtor immediately provide securities to cover the loan shortfall (then $166,000). At 2:00 p.m. the Debtor provided securities to cover its shortfall, but told the Bank that it would be a preference. At 4:10 p.m. an involuntary bankruptcy petition was filed against the firm. Would the payment made to the Bank only 4 hours after the loan was made be a contemporaneous exchange under 11 U.S.C. § 547(c)(1)? *National City Bank of NY v. Hotchkiss*, 231 U.S. 50 (1913).

Problem 2. Debtor's pizza parlor was having financial problems. On January 1, Debtor owed his long-time sausage supplier $20,000, and more than $300,000 to other creditors. On that date debtor gave his sausage supplier a security interest in his equipment (worth $100,000) to secure the sausage supplier's debt. Sausage supplier perfected the security interest within 30 days. The Debtor was insolvent at the time the security interest was given. On February 10, Sausage supplier delivered $10,000 worth of sausage to the Debtor. Debtor filed bankruptcy on March 10. Can the trustee avoid the security interest? *See* 11 U.S.C. § 547(c)(3), (e).

Problem 3. Debtor filed bankruptcy on December 31. Debtor's ledger card for his pepperoni and tomato sauce supplier shows the following transactions on the following dates. The payment column shows payments from the Debtor to the supplier, and the Deliveries column shows deliveries of pepperoni and tomato sauce. Calculate the amount that the trustee can recover as a preference assuming that the ordinary course of business exception does not apply. 11 U.S.C. § 547(c)(4).

File Date		31-Dec	
Pref Period		2-Oct	
	Deliveries	Payments	Balance
20-Sep			$25,000
30-Sep		$ 5,000	$20,000
1-Oct	$ 6,000		$26,000
4-Oct	$ 40,000		$66,000
8-Oct		$ 25,000	$41,000
10-Oct	$ 4,000		$45,000
12-Oct		$ 5,000	$40,000
20-Oct	$ 2,000		$42,000
30-Oct	$ 8,000		$50,000
10-Nov		$ 6,000	$44,000
11-Nov	$ 2,000		$46,000
30-Nov		$ 2,000	$44,000
1-Dec	$ 4,000		$48,000

Problem 4. Banco de Pizza gave the Debtor a $100,000 line of credit several years ago to start the pizzeria. At the time the loan was made, the Debtor signed a security agreement giving Banco a security interest in his inventory of flour, sauce, cheese, meats and vegetables. The value of the Debtor's inventory was in flux, because he would use ingredients to make pizzas, and then buy additional ingredients as its inventory started to get low. The debt also fluctuated because the Debtor's agreement with Banco required it to pay 80% of its daily collections on account of the loan. The following schedule shows the daily values of inventory and debt during the 90 days before bankruptcy. Calculate the amount of the preference, if any. *See* 11 U.S.C. § 547(c)(5).

Date	Inventory	Debt	Date	Inventory	Debt	Date	Inventory	Debt
31-Dec	$ 86,000	$ 84,000	30-Nov	$ 86,344	$ 87,553	31-Oct	$ 86,154	$ 89,500
30-Dec	$ 84,000	$ 90,000	29-Nov	$ 89,353	$ 86,004	30-Oct	$ 87,407	$ 87,055
29-Dec	$ 83,000	$ 90,000	28-Nov	$ 85,282	$ 89,433	29-Oct	$ 89,717	$ 89,977
28-Dec	$ 82,000	$ 89,000	27-Nov	$ 88,129	$ 85,683	28-Oct	$ 85,537	$ 89,895
27-Dec	$ 87,000	$ 88,000	26-Nov	$ 86,878	$ 89,714	27-Oct	$ 89,111	$ 86,962
26-Dec	$ 81,000	$ 87,000	25-Nov	$ 88,666	$ 85,512	26-Oct	$ 89,013	$ 89,982
25-Dec	$ 92,000	$ 89,000	24-Nov	$ 87,527	$ 86,713	25-Oct	$ 86,800	$ 88,205
24-Dec	$ 99,000	$ 90,000	23-Nov	$ 85,483	$ 88,301	24-Oct	$ 88,525	$ 88,332
23-Dec	$ 73,000	$ 79,000	22-Nov	$ 87,645	$ 89,956	23-Oct	$ 86,914	$ 88,864
22-Dec	$ 82,000	$ 82,000	21-Nov	$ 86,295	$ 85,545	22-Oct	$ 87,176	$ 89,800
21-Dec	$ 85,000	$ 88,000	20-Nov	$ 88,308	$ 88,821	21-Oct	$ 85,691	$ 88,920
20-Dec	$ 86,277	$ 85,881	19-Nov	$ 88,904	$ 89,383	20-Oct	$ 88,854	$ 88,422
19-Dec	$ 86,370	$ 88,911	18-Nov	$ 87,793	$ 87,210	19-Oct	$ 89,300	$ 88,442
18-Dec	$ 88,981	$ 89,894	17-Nov	$ 87,367	$ 88,038	18-Oct	$ 86,744	$ 87,054
17-Dec	$ 87,535	$ 86,901	16-Nov	$ 88,236	$ 89,130	17-Oct	$ 87,850	$ 88,896
16-Dec	$ 85,057	$ 85,638	15-Nov	$ 88,001	$ 89,430	16-Oct	$ 85,470	$ 87,413
15-Dec	$ 86,938	$ 87,156	14-Nov	$ 86,208	$ 86,375	15-Oct	$ 88,276	$ 87,504
14-Dec	$ 88,126	$ 86,934	13-Nov	$ 85,615	$ 87,005	14-Oct	$ 87,887	$ 88,633
13-Dec	$ 87,829	$ 89,990	12-Nov	$ 89,481	$ 86,484	13-Oct	$ 87,697	$ 89,330
12-Dec	$ 85,689	$ 87,242	11-Nov	$ 88,875	$ 86,656	12-Oct	$ 89,095	$ 85,158
11-Dec	$ 89,833	$ 89,901	10-Nov	$ 88,957	$ 88,089	11-Oct	$ 88,456	$ 85,831
10-Dec	$ 86,055	$ 85,483	9-Nov	$ 87,237	$ 88,727	10-Oct	$ 89,025	$ 86,765
9-Dec	$ 89,615	$ 88,645	8-Nov	$ 88,871	$ 86,636	9-Oct	$ 89,704	$ 85,567
8-Dec	$ 86,671	$ 86,171	7-Nov	$ 87,622	$ 89,803	8-Oct	$ 89,562	$ 85,058
7-Dec	$ 88,170	$ 89,107	6-Nov	$ 87,843	$ 86,462	7-Oct	$ 87,664	$ 88,113
6-Dec	$ 86,618	$ 88,932	5-Nov	$ 88,335	$ 87,994	6-Oct	$ 86,991	$ 88,814
5-Dec	$ 88,930	$ 89,886	5-Nov	$ 85,925	$ 85,672	5-Oct	$ 88,096	$ 86,015
4-Dec	$ 89,538	$ 87,534	4-Nov	$ 87,706	$ 87,887	4-Oct	$ 89,329	$ 89,004
3-Dec	$ 85,421	$ 87,052	3-Nov	$ 86,114	$ 89,138	3-Oct	$ 81,000	$ 93,000
2-Dec	$ 85,047	$ 86,040	2-Nov	$ 89,411	$ 87,878	2-Oct	$ 81,000	$ 93,000
1-Dec	$ 89,730	$ 89,148	1-Nov	$ 88,409	$ 88,612			

Problem 5. Debtor is a dealer in gold, and maintains an inventory of gold bars for sale to customers in the ordinary course of business. GoldBank has a perfected security interest in Debtor's inventory. 90 days before bankruptcy, the Debtor's inventory was worth $1 million and the loan balance was $1.1 million. On the date of bankruptcy, the value of the gold inventory

increased to $1.2 million even though no additional inventory was purchased or sold (because the price of gold went up during the 90 days before bankruptcy). The debtor's loan increased to $1.15 million. Has the creditor received a preference? Consider 11 U.S.C. §§ 547(c)(5), 547(b).

8.13. Statutory Liens – 11 U.S.C. § 545

Statutory liens are created by state law to benefit certain favored creditors, such as mechanics who make improvements to property but are not paid for the improvements. The Bankruptcy Code respects most statutory liens, but recognizes that states may attempt to upset the priority scheme in bankruptcy by creating statutory liens that only apply in bankruptcy. Just as the Bankruptcy Code invalidates ipso-facto clauses, Section 545(1) invalidates these "bankruptcy-only" statutory liens.

Section 545(2) invalidates unperfected statutory liens – those not enforceable against a bona fide purchaser on the filing date. This is consistent with the trustee's strong arm powers.

Section 545(3) invalidates landlord statutory liens. Some states, at least at one time, gave landlords a statutory lien on the tenant's personal property to sure the obligation to pay rent. These liens are invalidated because they are simply too harsh.

8.14. Setoffs – 11 U.S.C. § 553

State laws generally allow a party to offset mutual debts with another party. If A owes B $100, and B owes A $40, A can offset the debts and satisfy the obligation by paying B $60. Setoffs avoid the risk of a counter party's default (A pays B $100, but B doesn't pay A the $40 that is owing back), and avoid unnecessary transaction costs.

A bank's right of setoff is well recognized. If a debtor has money on deposit with a bank, and owes the bank a debt, the bank may offset the deposit against the debt at any time, so long as the debt is due. While the automatic stay prevents the bank from exercising its right of setoff during the case, 11 U.S.C. § 362(a)(7), the Supreme Court has recognized that the bank may impose an administrative freeze on deposited funds subject to setoff to prevent losing its setoff rights during the pendency of the automatic stay. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995). When the stay terminates or is relieved, the bank may exercise its setoff rights. Setoffs have the same effect as secured claims, granting the party with the setoff right a priority claim against and interest in the property subject to setoff.

Section 553(a) of the bankruptcy code preserves the right of setoff as long as the two reciprocal claims are allowed, of the same class (unsecured), and arise prepetition. A creditor cannot offset a prepetition claim against the debtor (that will be paid in depreciated bankruptcy dollars) against a post-petition obligation to the debtor (that will be paid in real dollars).

Section 553(a)(2) contains a mini preference provision preventing the transfer of setoff claims during the preference period to obtain setoff priority. To illustrate the problem, assume the Debtor owes $100 to Creditor A, and Creditor B owes $100 to the Debtor. Also assume that the Debtor is 50% insolvent. In Bankruptcy, Creditor B would pay $100 to the estate, and Creditor A

would get $50. If Creditor A transferred the claim to Creditor B during the preference period, and the setoff were allowed, the estate would get $50 less than it would if the claim had not been transferred. Transferred setoff claims create preferences that can generally be avoided in bankruptcy.

Finally, Section 553(b)(1) of the Bankruptcy Code contains a reduction in insufficiency test designed to catch the use of setoffs that create improvement in position during the preference period. The test leaves an important gap. The test and the gap are illustrated by the following problems.

8.15. Practice Problems: Setoff Preferences

Problem 1. Debtor owes Bank $500,000 on a line of credit, and is having severe financial problems. In order to keep good relations with the Bank, Debtor offers to pay the line of credit before filing bankruptcy. The Bank knows that this will result in a preference. Instead, the Bank suggests that the Debtor deposit $500,000 in a bank account. After the Debtor makes the deposit, the Bank exercises its right of setoff. The Debtor files bankruptcy within 90 days after making the deposit. 11 U.S.C. § 553(b)(1).

Problem 2. On the same facts, what if the Bank does not exercise the right of setoff prior to bankruptcy and wants relief from stay to do so? 11 U.S.C. § 553(a)(3).

Problem 3. Would it make any difference in Problem (2) if the Debtor just deposited $500,000 in the Bank without any discussion about paying the Bank a preference?

Problem 4. Debtor owes money to the IRS, and is owed money on a federal government contract with the US Air Force. Can the federal government claim a right of setoff, or do the claims lack mutuality because the IRS and Air Force are separate creditors?

8.16. Cases on Setoffs

8.16.1. DURHAM v. SMI INDUSTRIES, INC., 882 F.2d 881 (4th Cir. 1989)

SMI and Continental are scrap metal dealers that until November 1983 engaged in a substantial amount of business with each other, selling each other materials on open account. Although the total dollar figures of the open account invoices often grew quite large, the net balance due either party at any one time was relatively small. Periodically, in order to reduce these account debts, SMI and Continental would either make mutual accounting entries cancelling corresponding debts and credits, or they would exchange checks for the outstanding balances. The check exchanges were carefully coordinated to allow simultaneous deposits in their respective bank accounts to ensure that the checks would clear.

In late August 1983 SMI and Continental made such a check exchange. Continental sent SMI 17 checks totaling $273,137.62 from August 25 to August 26, representing amounts it owed

SMI for invoiced deliveries from September 3, 1982 to June 28, 1983. On August 29 SMI sent Continental its check for $271,967.20 for invoiced deliveries by Continental from February 22, 1983 through August 16, 1983. Both parties deposited the checks into their bank accounts on August 30.

On November 18, 1983, less than 90 days later, Continental filed a petition in bankruptcy under Chapter 7. In November 1985 Continental's Trustee filed an adversary action against SMI seeking to recover $273,137.62, which represented the total amount of the checks Continental had sent SMI as part of the check exchange. The bankruptcy court held in favor of the Trustee, finding that Continental's remittance of the checks to SMI constituted avoidable preferential transfers that were not part of a valid setoff. The district court affirmed.

Section 547(b) provides that a trustee may avoid, and proceed to seek recovery of, any transfer made by a debtor to a creditor within 90 days prior to filing for bankruptcy that has the effect of enabling that creditor to receive more than it would in the bankruptcy proceeding had the transfer not been made. However, under section 553(b), a valid setoff executed within 90 days of the date of the filing of a bankruptcy petition is nonetheless protected from avoidance under section 547, except for any insufficiency. Where a pre-petition setoff is asserted in defense to a proceeding brought by a trustee the court must first determine whether the setoff is valid under section 553. Only if the court finds the setoff invalid, and further concludes that no right of setoff exists in bankruptcy, is section 547 applied. We hold that the lower courts erred by attempting to resolve this case under section 547 after SMI asserted that it and Continental had completed a pre-petition setoff of their mutual debts.

Section 553 does not create a right of setoff or prescribe the means by which a setoff must be executed in order to be effective. It merely preserves any right of setoff accorded by state law, subject to certain limitations. North Carolina has long recognized the right of setoff where mutual debts exist between parties. North Carolina has not, however, prescribed any method by which a setoff must be executed to be valid.

The United States Supreme Court, applying the former Bankruptcy Act, recognized that a pre-petition setoff may be effected where parties with mutual debts have "themselves given checks, charged notes, made book entries, or stated an account whereby the smaller obligation is applied on the larger." The Trustee concedes that had the parties executed this setoff by corresponding accounting entries it would have been valid, but he argues that a setoff may not be effected by exchanging checks. We see no reason to distinguish between the two practices. Indeed, the exchange of checks, with the resulting endorsements each made on the other's checks before depositing them, provided better documentation of satisfaction of the debt than mere book entries. We hold that the check exchange constituted an effective exercise of setoff pursuant to North Carolina law and section 553(b).

The lower courts used "hypothetical facts" to ignore the intent of the parties at the time of the check exchange and to view each party's act of sending a check as the independent payment of a valid debt.

However, the clear intent of the parties, as expressed through their overt acts, may not be so readily ignored. As part of their general and longstanding business practice SMI and Continental customarily accrued and then set off, sometimes by accounting entries and sometimes by check exchange, debts to the other. In the check exchange in question SMI and Continental took every

step possible to ensure that their checks would cross in the collection process since neither had funds sufficient to cover their checks. As neither intended a substantial amount of money to change hands, there was no need to have sufficient funds on hand, apart from the coordinated deposits of the other's check, to ensure that their own check would clear. Although checks were used, in essence the exchange constituted an accounting exercise to clear their books of mutual debts.

SMI would have been entitled to assert its right of setoff under section 553(a) post-petition if the check exchange had not been executed before Continental's petition was filed since both debts were incurred pre-petition. Where a creditor fails "to exercise its right of setoff prior to the filing of the petition" it does not lose the right, but must "proceed in the bankruptcy court by means of a complaint to lift the automatic stay so as to be allowed to exercise its already existing right to offset." And, as the Trustee concedes, there is no evidence that the debt SMI extinguished in the setoff was incurred either fraudulently or "'for the purpose of obtaining a right of setoff against the debtor.' "11 U.S.C. Sec. 553(a)(3)(C)). It would be inequitable to construe section 553(b) to prevent "the parties from voluntarily doing, before the petition is filed, what the law itself requires to be done after proceedings in bankruptcy are instituted."

Since the debts the two parties eliminated with the setoff were not exactly the same, the resulting checks were not equal. The check exchange was a proper setoff only up to the amount that SMI and Continental owed each other equivalent amounts. Since SMI sent Continental $271,967.20 while receiving from Continental $273,137.62, an insufficiency of $1,170.42, recoverable from SMI, was created pursuant to sections 553(b)(1) and (b)(2). SMI must return this insufficiency to Continental's estate.

8.17. The "Mutuality" Requirement

Section 553 of the Bankruptcy Code preserves the state-law rights that creditors have under state law to setoff mutual prepetition debts. A creditor cannot setoff a debt owing by the debtor to the creditor post-petition against the creditor's obligation to pay a prepetition debt, because the debts are not mutual.

Many courts have rigidly applied the "mutuality" requirement to prohibit bankruptcy setoffs that would have been allowed under applicable state law outside of bankruptcy. For example, in *In re Orexigen Therapeutics, Inc.*, 990 F. 3d 748 (3d Cir. 2021), McKesson contracted to distribute through its various subsidiaries drugs manufactured by Orexigon. The contract provided that McKesson could offset any debts owing by Orexigon to any of its subsidiaries against debts owing by McKesson or its other subsidiaries to Orexigon. At the time of Orexigon's bankruptcy, McKesson owed Orexigon $7 million, and Orexigon owed a McKesson subsidiary called McKesson Patient Relationship Solutions ("MPRS") $9 million. McKesson sought to avoid payment of the $7 million by asserting its right to offset the MPRS claim.

McKesson argued that the Bankruptcy Code preserves setoffs authorized by state law, and the parties explicitly provided in their contract for the setoff of debts owing to McKesson's subsidiary. The court held, however, that the debts were not "mutual" within the meaning of the bankruptcy code, because there was no debt owed to McKesson directly that could offset McKesson's liability to Orexigen. The court explained the reason for the mutuality requirement as follows:

> Congress intended for mutuality to mean only debts owing between two parties, specifically those owing from a creditor directly to the debtor and, in turn, owing from the debtor directly to that creditor. Congress did not intend to include within the concept of mutuality any contractual elaboration on that kind of simple, bilateral relationship.
>
> Given basic premises of the Bankruptcy Code, that is not surprising. "[S]etoff is at odds with a fundamental policy of bankruptcy, equality among creditors, because it permits a creditor to obtain full satisfaction of a claim by extinguishing an equal amount of the creditor's obligation to the debtor, i.e., in effect, the creditor receives a preference." Thus, we and our sister circuits have indicated that triangular setoffs — in which party A owes party B who next owes party C who then owes party A — are definitionally not mutual.

In re Orexigen Therapeutics at 754. Therefore, McKesson had to pay the $7 million in cash to Orexigen, and would be repaid the $9 million Orexigen owed to MPRS in bankruptcy dollars.

8.18. Unauthorized Post-Petition Transfers – 11 U.S.C. § 549

We have already seen that Section 363 limits the power of the trustee (or the debtor in possession in a Chapter 11 case) to engage in post-petition transactions. As we have seen, under Section 363(b)(1), the trustee may use, sell or lease property outside of the ordinary course of business only with bankruptcy court approval, and under Section 363(c)(2) may not use cash collateral without the consent of the secured creditor or an order from the court authorizing the use. A secured party at any time is entitled to adequate protection in connection with any use, sale or lease of property of the estate. 11 U.S.C. § 361. But what are the consequences of engaging in unpermitted post-petition transactions? Section 549 allows the trustee (or debtor in possession in a Chapter 11 case) to avoid any transaction that was "not authorized under this title or by the court." Section 549(c) contains an exception protecting a good faith buyer of real property who was not aware of the bankruptcy case if no notice of bankruptcy was filed in the real estate records.

Note that Section 549(d) contains a special statute of limitations terminating claims under Section 549 which are not brought before the bankruptcy case is closed, or within 2 years from the transfer, whichever is earlier.

We have previously seen in *Marathon Petroleum v. Cohen*, 599 F.3d 1255 (11th Cir. 2010), how dangerous it is to engage in transactions with the debtor without obtaining court approval, unless it can clearly be shown that the transaction was in the "ordinary course of business" and did not involve cash collateral.

8.19. Statute of Limitations on Avoiding Powers – 11 U.S.C. § 546(a)

Avoidance actions must generally be brought within two years after the bankruptcy case is commenced. A trustee has at least one year after appointment to exercise avoiding powers. So, for example, if a debtor in possession operated for three years in a Chapter 11 case before conversion to Chapter 7 or the appointment of a Chapter 11 trustee, the trustee would still get a year to file avoidance actions even though the debtor's time to avoid had expired. A trustee loses the avoidance power when a case is closed or dismissed.

8.20. Relation-back Perfection Rules – 11 U.S.C. § 546(b)

If perfection of a lien relates back for priority purposes to an earlier time under state law, the strong arm and other avoidance powers can only be applied after considering that relation-back. For example, even though a purchase money security interest was not perfected on the date of bankruptcy, if the 20 day relation-back period under state law has not expired (UCC §§ 9-317(e), 9-324(a)), the interest can be perfected post-petition (*See* 11 U.S.C. § 362(b)(3)), and the trustee's strong arm powers cannot be used to avoid the security interest on the grounds that the interest was not perfected on the date of bankruptcy.

Furthermore, if state law requires a suit to be filed or property to be seized in order to perfect an interest that relates back, the creditor can perfect post-petition by simply giving notice. 11 U.S.C. § 546(b)(2) flush language. This commonly applies to lenders who wish to perfect an assignment of rents clause in a mortgage, where state law requires the lender to seize the rents outside of bankruptcy (generally by asking for the appointment of a receiver), and to the perfection of statutory mechanics liens which often require the commencement of an action against the property owner within a certain period of time. Since the creditor is automatically stayed from seizing or suing, giving notice accomplishes the perfection.

8.21. Reclamation Rights – 11 U.S.C. § 546(c)

Reclamation is a trap for lawyers that is buried deep in the bowels of the Bankruptcy Code. One of my law partners was sued for legal malpractice for failing to advise a client to file a reclamation demand, so I am particularly sensitive to the need for caution.

Reclamation is the right of a seller of goods to stop the goods in transit and recover them, or demand the return of the goods delivered to a buyer, upon learning of the buyer's insolvency. Section 2-702 of the Uniform Commercial Code allows a seller who discovers that the buyer is insolvent to stop delivery and demand cash for prior and current shipments. Of more importance is the seller's right to reclaim goods upon learning of the buyer's insolvency after delivery. Section 2-702 of the Uniform Commercial Code (standard version) provides

> (2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency

> has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply.
>
> * * *
>
> (3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article.

The revised version of UCC 2-207 eliminates the 10 day rule entirely, allowing a reclamation demand to be made within "a reasonable time after the buyer's receipt of the goods."

Section 546(c) of the Bankruptcy Code does not by its terms create a special reclamation right, but merely provides that the trustee's avoiding powers are limited by the rights of a reclaiming seller for goods received by the debtor within 45 days before the bankruptcy filing. The seller must make the demand within 45 days after the debtor's receipt of the goods, or within 20 days after bankruptcy if the 45 day period has not expired by the petition date.

As an alternative to reclamation, the Bankruptcy Code since 2005 has given an administrative claim to the seller of goods delivered to the debtor within 20 days **before** bankruptcy. 11 U.S.C. § 503(b)(9). Prior to 2005, this section gave the bankruptcy court the alternate power to grant the reclaiming creditor an administrative claim in lieu of returning the goods. The creditor can now elect between an administrative claim or reclamation.

Both the Bankruptcy Code and the UCC recognize that the reclamation demand may be subordinate to the rights of buyers and other good faith "purchasers," a definition which includes secured creditors. UCC 2-702(3); 11 U.S.C. § 546(c)(1) ("subject to the prior rights of a holder of a security interest in such goods.") The relative rights of reclaiming sellers and secured creditors (who are "purchasers" under the UCC) are explored in the cases that follow.

8.22. Cases on Reclamation Rights

8.22.1. IN RE ARLCO, INC., 239 B.R. 261 (Bankr. S.D.N.Y. 1999)

On June 6, 1997, Arley Corporation and Home Fashions each filed a petition under chapter 11 of the Bankruptcy Code. Arley [manufactured and sold home furnishings to retailers,] one of which was Home Fashions, Arley's wholly-owned subsidiary.

On September 15, 1997, pursuant to 11 U.S.C. § 363, the Court approved an asset purchase agreement for the sale of substantially all of the Debtors' assets as a going concern. On August 6, 1998, the Debtors chapter 11 cases were converted to chapter 7.

Galey is a fabric manufacturer that sold textile goods on credit to Arley. On May 16, 1997, Galey sent a letter to Arley by fax, overnight courier, and certified mail (the "May 16th Letter") demanding that Arley return the merchandise it "received during the applicable periods referred to in [§ 2-702 of the Uniform Commercial Code]" and notifying Arley that "all goods subject to [Galey's] right of reclamation should be protected and segregated by [Arley] and are not to be used for any purpose whatsoever." Subsequently, on May 21, 1997, Galey sent the Debtor an additional

notice detailing each invoice issued to Arley within the 10-day period prior to May 16, 1997 for the goods allegedly subject to reclamation.

Since early 1995, CIT Group/Business Credit Inc. ("CIT") has held a perfected security interest in substantially all Arley's assets, including accounts receivable and inventory.

On June 9, 1997, prior to the sale of the Debtors' assets, Galey commenced an adversary proceeding against Arley seeking reclamation of the textile goods referred to in the May 16th Letter. Currently before the Court are motions for summary judgment filed by Galey and by the Trustee, respectively.

In its summary judgment motion, Galey maintains that it has complied with all the statutory requirements for establishing a valid claim for reclamation. The Trustee refutes Galey's contention and opposes entry of summary judgment in favor of Galey. Rather, the Trustee maintains that his arguments support entry of summary judgment in Arley's favor. The three principal reasons advanced by the Trustee in opposition to Galey's motion and in support of his own motion are that . . . 3) Galey's right to reclamation is subject to CIT's perfected security interest.

The purpose of 11 U.S.C. § 546(c)[1] is to recognize any right to reclamation that a seller may have under applicable nonbankruptcy law. Section 546(c) does not create a new, independent right to reclamation but merely affords the seller an opportunity, with certain limitations, to avail itself of any reclamation right it may have under nonbankruptcy law. Pursuant to § 546(c), a seller may reclaim goods it has sold to an insolvent debtor if it establishes:

(1) that it has a statutory or common law right to reclaim the goods;

(2) that the goods were sold in the ordinary course of the seller's business;

(3) that the debtor was insolvent at the time the goods were received; and

(4) that it made a written demand for reclamation within the statutory time limit after the debtor received the goods.

In addition, to be subject to reclamation, goods must be identifiable and cannot have been processed into other products. It has also been noted that "an implicit requirement of a § 546(c) reclamation claim is that the debtor must possess the goods when the reclamation demand is made." However, it is not clear "whether possession is an element under § 546(c) of the Bankruptcy Code or in establishing an independent right of reclamation under nonbankruptcy law to be recognized under § 546(c)." Logic dictates that, if not possession, the debtor should at least have control over the goods if it is to be required to return them. For the same reason, if the goods are not identifiable, the debtor could not identify or extract the goods to return them to the reclaiming seller. The issue concerning control of the goods or the identifiable nature of the goods would be relevant whether or not the reclaiming seller is seeking the goods in a bankruptcy context. Thus, it appears that these elements are requirements under the "independent right of reclamation under nonbankruptcy law."

Section 546(c) also affords the bankruptcy court broad discretion to substitute an administrative claim or lien in place of the right to reclaim. This discretion gives the court needed flexibility and permits it to recognize the reclaiming creditor's rights while allowing the debtor the opportunity to retain the goods in order to facilitate the reorganization effort.

Uniform Commercial Code ("U.C.C.") § 2-702[(2)] as enacted in various jurisdictions, ordinarily forms the statutory right upon which sellers base their reclamation demand. Pursuant to U.C.C. § 2-702(3), the seller's right to reclamation is "subject to" the rights of a good faith purchaser from the buyer. That the right of a reclaiming creditor is subordinate to that of a good faith purchaser does not automatically extinguish the reclamation right. Rather, the reclaiming creditor is "relegated to some less commanding station."

Most courts have treated "a holder of a prior perfected, floating lien on inventory . . . as a good faith purchaser with rights superior to those of a reclaiming seller." A "purchaser" is defined as one "who takes by purchase," U.C.C. § 1-201(33), and "purchase" is defined to include "taking by sale, discount, negotiation, mortgage, pledge, lien, issue or re-issue, gift or any other voluntary transaction creating an interest in property." U.C.C. § 1-201(32). Thus, the definition of purchaser is broad enough to include an Article 9 secured party, which then qualifies as a purchaser under U.C.C. § 2-403. Thus, in the instant case, if CIT qualifies as a good faith purchaser then even if Arley had voidable title to the goods, it could transfer good title under Article 2 to CIT. Further, if CIT obtained the goods in this manner, the demand of a reclaiming seller is subject to CIT's interest. [The Court then concludes that Galey has failed to allege facts to show that CIT is not a good faith purchaser].

As previously noted, while a seller's right to reclamation is subject to the rights of a good faith purchaser, the reclamation right is not automatically extinguished. Relying on this principle, Galey argues that, pursuant to § 546, it is entitled to either an administrative claim or lien in lieu of its right to reclamation. . . . Galey contends that because there will be surplus collateral once CIT has been paid in full, that collateral should be used to pay Galey's reclamation claim and it should get its administrative claim or lien on that surplus.

[T]he Trustee argues that when the goods subject to a reclamation demand are liquidated and the proceeds are used to pay the secured creditor's claim, the reclaiming seller's subordinated right is rendered valueless. The Trustee maintains that once the secured creditor is paid in full, the reclaiming seller is only entitled to reclamation when the surplus collateral remaining consists of the very goods sold by the reclaiming seller or the traceable proceeds from those goods.

Courts differ on the treatment to be afforded reclaiming sellers subject to the superior rights of good faith purchasers. Some courts have awarded a reclaiming seller, who otherwise meets the criteria to qualify as a reclaiming seller but is subject to a superior claim, an administrative claim or replacement lien for the full amount of the goods sought to be reclaimed. However, the majority view appears to be some method of assuring that the reclaiming seller only receive what it would have received outside of the bankruptcy context after the superior claim was satisfied. **Thus, it is only when the reclaiming seller's goods or traceable proceeds from those goods are in excess of the value of the superior claimant's claim that the reclaiming seller will be allowed either to reclaim the goods or receive an administrative claim or lien in an amount equal to the goods that remain after the superior claim has been paid. Allowing the reclaiming seller to recover only that to which it would be entitled absent the bankruptcy is in keeping with the purpose § 546(c) which is to preserve any common law or statutory rights to reclamation, not to enhance those rights. It therefore follows that any administrative claim or lien substituted for the right to reclamation pursuant to § 546(c) should be "allowed only to the extent of the value of the lost right of reclamation."** If the right to reclamation would be worthless absent the bankruptcy filing, it is also worthless in bankruptcy. Indeed, granting an

administrative claim or lien when the secured creditors have paid their claims out of the goods to be reclaimed "would afford the reclamation seller something it does not have under the UCC—a priority interest in the buyer's assets other than the goods to be reclaimed."

Thus, while the reclaiming seller's claim is not automatically extinguished, the reclaiming seller is also not automatically granted an administrative claim or lien in the full amount sought when it is subject to the rights of the good faith purchaser. Rather, the reclaiming seller's right to reclaim depends on the value of the excess goods remaining once the secured creditor's claim is paid or released.

As the bankruptcy filing does not enhance the reclaiming seller's rights, the Court should determine what would have happened to the reclaiming seller's claim in a nonbankruptcy context. The parties concede that under state law the secured creditor would have the option of proceeding against any of its collateral. Therefore, the secured creditor may choose to foreclose on the goods sold by the reclaiming seller if these goods can be readily liquidated. When the secured claim, or a portion of it, is paid out of the goods sought to be reclaimed, the right to reclaim is rendered valueless. Thus, "in the non-bankruptcy context, the secured creditor's decision with respect to its security interest in the goods will determine the value of the seller's right to reclaim." Here, following the Debtors' filing, CIT decided not to seek relief from the Court to pursue those remedies available to it to secure the immediate liquidation of all the Debtors' assets. Rather, it supported the Debtors' efforts to sell its inventory including any Galey goods in the ordinary course of its business. As a result, all of the goods which Galey sought to reclaim were sold and the proceeds used to pay CIT. Moreover, even after CIT received payment from the sale of the goods, there was still a balance due it. Thus, Galey's reclamation claim was rendered valueless.

Galey concedes that CIT's security interest is of a greater value than the value of the goods upon which Galey bases its reclamation claim. Nevertheless, inasmuch as it now appears that CIT's security interest will ultimately be satisfied through the continued liquidation of its remaining collateral, Galey argues that the Court should use its equitable power and afford it relief based upon a marshaling theory.

The equitable principle of marshaling of assets applies when a senior secured creditor can collect on its debt against more than one property or fund held by the debtor but a junior secured creditor can only proceed against one of those sources. The principle benefits the junior secured creditor by requiring the senior secured creditor to first attempt to collect amounts owed it from the property or fund in which the junior secured creditor has no interest, thereby producing a greater possibility that there will be remaining value in the only fund from which the junior secured creditor can be paid to allow for a payment to it.

To apply marshaling, three elements must be established by clear and convincing evidence (1) the existence of two secured creditors with a common debtor, (2) the existence of two funds belonging to the debtor, and (3) the right of the senior secured creditor to receive payment from more than one fund while the junior secured creditor can only resort to one fund. These three requirements have been strictly construed in the bankruptcy context. "An unsecured creditor has no standing to invoke the doctrine." Moreover, marshaling is not applied if either a senior secured creditor or other parties are prejudiced. Thus, it is not applied when the senior secured creditor would be delayed or inconvenienced in the collection of the debt owed it. A secured creditor may properly proceed first to collect against "readily available collateral." The senior secured creditor

will not be required to proceed first against a fund that requires more rigorous procedures to collect upon if it has a fund "more directly available" to it that can be "easily reduced to money."

As a threshold matter, marshaling is not applicable in this case because the first requirement for its application is not met in that Galey is not a secured creditor. Although Galey argues that its claim has a higher priority than general unsecured claims and that its claim is akin to a secured claim, Galey, nevertheless, does not have a secured claim. Further, with respect to Galey's assertion that a reclaiming creditor's rights are superior to those of a general unsecured creditor, the Court notes that the reclaiming creditor's claim is only superior to that of an unsecured creditor to the extent its reclamation claim is found to have value, however, with respect to that portion of the reclaiming creditor's claim in excess of that value, the reclaiming seller is an unsecured creditor.

In the case before this Court, CIT could have sought Court approval to foreclose on all its collateral, including the Galey goods, immediately. However, CIT chose to consent to the Debtor's decision to continue in business with the expectation that as a going concern the return on CIT's collateral would increase. . . . It is clear that whatever Galey goods may have been present on the date of the demand —all of which goods were subject to CIT's rights—were sold or processed into finished products and sold. . . . Thus, all of the traceable proceeds from any Galey goods were used to pay CIT.

In summary, in the context of a secured creditor that qualifies as a good faith purchaser, the value of the reclaiming seller's reclamation claim will depend on whether the goods or the proceeds from those goods have been used to satisfy the secured creditor's claim. Once the goods or the proceeds from the sale of those goods have been "paid" to the secured creditor, the reclaiming seller's claim in those goods is valued at zero, regardless of whether the secured creditor is ultimately paid in full and its lien is released as to other collateral.

Finally, because this Court finds that Galey is not entitled to an administrative claim or replacement lien inasmuch as any right to reclamation it might have was subject to CIT's security interest and was rendered valueless by CIT's interest, it is unnecessary for the Court to reach the issue of whether Galey otherwise complied with all the requirements for a right to reclamation.

8.22.2. PHAR-MOR v. McKESSON CORPORATION, 534 F.3d 502 (6th Cir. 2008)

At issue in this bankruptcy case is whether a vendor's administrative-expense priority on its reclamation claim is effectively extinguished when the goods subject to reclamation are sold and the proceeds used to satisfy a secured creditor's superior claim. Because we hold that it is not, we AFFIRM the district court's decision.

Phar-Mor filed Chapter 11 bankruptcy on September 24, 2001, but continued to operate as a debtor in possession. In response, several vendors, including McKesson Corporation, filed timely "reclamation claims," pursuant to 11 U.S.C. § 546(c) and UCC § 2-702, seeking to recover goods they had delivered to Phar-Mor on credit. On October 5, 2001, Phar-Mor proposed "that each Vendor be granted an administrative expense priority claim under Section 503(b) in the amount (if any) of its allowed reclamation claim," and reported reclamation claims from 141 vendors totaling $18 million. All but McKesson have since settled.

On the petition date, Phar-Mor owed its secured creditors $103 million. The bankruptcy court authorized Phar-Mor to borrow up to $135 million to repay these pre-petition secured creditors. Phar-Mor did so and those security interests were extinguished. Phar-Mor gave the new creditors (i.e., "DIP Lenders") super-priority status over the remaining security interests, which also meant that their claims had priority over any administrative expense claims, such as McKesson's.

Upon entering bankruptcy, Phar-Mor closed 65 stores and held going-out-of-business sales, which generated $30 million. Phar-Mor continued to lose money, continued to close stores, and eventually had a final going-out-of-business-liquidation sale, which generated $103 million. Phar-Mor was able to pay off the $135 million post-petition loan from the DIP Lenders and was left with $64.5 million. After expenses, fees, and the money allotted to payment of the reclamation claims, $30 million was left towards payment of $185.5 million in general unsecured claims.

On February 13, 2003, Phar-Mor moved the bankruptcy court to reclassify the reclamation claims as general unsecured claims. Phar-Mor argued that the vendors' administrative-expense priority was extinguished when the goods subject to reclamation were sold and the proceeds used to pay off the DIP Lenders. The court denied the motion and held that, even though the reclamation claims were rendered "subject to" the DIP Lenders' super-priority, the vendors' properly filed reclamation claims still had administrative-expense priority over the general claims.

Phar-Mor moved the bankruptcy court for reconsideration (twice), and was denied (twice); appealed to the district court, which affirmed the bankruptcy court; and now appeals to this court — each time asserting the same arguments that it had asserted to the bankruptcy court in the first instance. Because we find that the bankruptcy court properly granted McKesson an administrative expense priority in lieu of its reclamation claim, we affirm the bankruptcy court's decision.

There is no question that McKesson sold goods to Phar-Mor in the ordinary course of its business, that Phar-Mor received the goods while insolvent, or that McKesson, upon discovering Phar-Mor's insolvency, made a timely, written demand for reclamation. The immediate question is whether McKesson had a statutory or common-law right, pursuant to Ohio law, to reclaim those goods. If so, then the court, having denied reclamation, was obligated to grant McKesson either an administrative-expense priority in the amount of the goods (as it did) or a lien on the proceeds resulting from the use of those goods by the debtor. But if not, then the court was not so obliged and McKesson's claim for the value of those goods may be properly regarded as merely a general unsecured claim.

Phar-Mor argues, however, that McKesson did not have a right to reclaim the goods because McKesson did not have the ability to reclaim those goods, inasmuch as [the UCC] renders a seller's right to reclaim "subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor." Phar-Mor contends that the DIP Lenders, who held a security interest in all of Phar-Mor's inventory, via an after-acquired-property clause in their security agreement were "good faith purchasers." Thus, Phar-Mor surmises that, because McKesson's reclamation rights are "subject to" the DIP Lenders' security interest and because Phar-Mor sold McKesson's "reclamation goods" to satisfy the DIP Lenders' claim, McKesson is unable to reclaim the goods and, hence, is left without any right to reclaim the goods. . . .

[The court then discusses various cases, specifically rejecting the *Galey* opinion, and quoting with approval from *In re Am. Food Purveyors, Inc*., 17 UCC Rep. Serv. 436, 1974 WL 21665 (Bankr. N.D. Ga.1974):

> The issues of good faith, notice and knowledge are important here because the after-acquired-property secured creditor is attempting to acquire rights over goods which were essentially being held in trust by the debtor/buyer for the seller, because of their acquisition by fraud. It was as if the debtor/buyer never had obtained title, and the seller is essentially trying to retake his own property. For these reasons, and because this is a court of equity and guided by equitable doctrines and principles, it was essential that the creditor demonstrate that it was in good faith and had no knowledge or notice of the debtor/buyer's financial plight, in order to prevail.
>
> For the reason that the property was still the seller's even after it was delivered, at least for the ten day period provided for in § 2-702, the court finds further that the creditor acquired no `rights in the collateral' as required under UCC § 9-204, in regard to the goods. . . . [A] secured party's rights, generally speaking, against the debtor's vendor are no greater than the debtor himself.
>
> The court finds that rights under § 9-204 of the UCC means an ownership claim paramount to that of the seller and capable of specific enforcement in equity. Consequently, for the ten day period in question, the debtor/buyer could not have sustained an action in equity to keep these goods. All of the rights during this period were with the defrauded seller.

This reasoning is persuasive.

We find that UCC 2-207(2) grants a properly reclaiming vendor, such as McKesson, a right to reclaim its goods and that UCC 2-207(3) does not allow a secured creditor's claim to defeat that right. But, correspondingly, we find that 11 U.S.C. § 546(c)(2) (1998) grants the bankruptcy court the power to deny a properly reclaiming vendor, such as McKesson, its right to reclaim the goods, but only by granting the denied vendor either an administrative-expense priority in the amount of the goods or a lien on the proceeds resulting from the use of those goods by the debtor. In this case, the bankruptcy court granted McKesson an administrative-expense priority, and we have no basis to overturn its decision in this matter.

8.23. Recovering Avoided Transfers – 11 U.S.C. § 550

Section 550 puts important additional limits on the ability to recover avoided transfers. Not all avoided transfers need to be recovered. There is no need for a recovery if the granting of a lien is avoided – the creditor is simply made unsecured. But if after avoiding a transfer the trustee wants to recover money or the property from someone then the strictures of Section 550 come into play.

Section 550 provides protection for (1) innocent secondary transferees (11 U.S.C. § 550(b)); (2) non-insider transferees outside of the 90 day period (11 U.S.C. § 550(c)); and (3) good faith transferees who gave value (11 U.S.C. § 550(d)). It also adds a one year statute of limitations on recovery following avoidance of the transfer. 11 U.S.C. § 550(f).

8.24. Practice Problems: Recovering Avoided Transfers

Problem 1. Bank lends $100,000 to the debtor, unsecured, guaranteed by the debtor's rich mother. Debtor repays the loan 91 days before filing bankruptcy. Can the trustee recover the $100,000 from the Bank?

> [This is a simplified example of the problem identified in *In re Deprizio Constr. Co.*, 874 F.2d 1186, 1200-1201 (7th Cir. 1989), decided before Congress attempted to fix the problem by enacting 11 U.S.C. § 550(c). Since the transfer **benefitted** an insider it was subject to the one year avoidance period even though the transfer was not **made to** an insider.]

Problem 2. Bank lends $100,000 to the debtor, unsecured, guaranteed by the debtor's rich mother. Debtor grants a security interest to the Bank to secure the loan 91 days before filing bankruptcy. Can the trustee avoid the security interest?

> **[NOTE: Because Section 550(c) did not completely fix this problem (where no recovery is required), Congress again amended the Bankruptcy Code by adding 11 U.S.C. § 547(i).]**

8.25. Cases on Recovering Avoided Transfers

8.25.1. BONDED FIN. SERV., INC., v. EUROPEAN AMERICAN BANK, 838 F.2d 890 (7th Cir. 1988)

EASTERBROOK, Circuit Judge.

Michael Ryan controlled a number of currency exchanges in Illinois. He also owned quite a few horses, doing business as Shamrock Hill Farm. Ryan had borrowed $655,000 from European American Bank to run this business. One of the currency exchanges, Bonded Financial Services, put $200,000 at Ryan's disposal in January 1983. Bonded sent the Bank a check payable to the Bank's order on January 21 with a note directing the Bank to "deposit this check into Mike [Ryan]'s account." The Bank did this. On January 31 Ryan instructed the Bank to debit the account $200,000 in order to reduce the outstanding balance of the Shamrock loan. The Bank did this. Ryan paid off the loan in two more installments, on February 11 and 14, 1983. The Bank released its security interest in the horses.

The currency exchanges and Ryan paid visits to the judicial system. Bonded filed a petition in bankruptcy on February 10, 1983, along with about 65 other entities that Ryan controlled. Creditors later filed involuntary proceedings against Ryan. Ryan was convicted of mail fraud on

account of his irregular administration of the currency exchanges (Bonded was not, for starters) and is in prison. The transfer of $200,000 out of Bonded on January 21, 1983, was a fraudulent conveyance and the trustee may recover for the benefit of creditors the value of such a conveyance. The trustee seeks to recover from the Bank, which unlike Ryan is solvent.

Bonded's trustee contends in this adversary proceeding that the Bank is the "initial transferee" under Sec. 550(a)(1) because it was the payee of the check it received on January 21; that the Bank is in any event the "entity for whose benefit such transfer was made" because Ryan intended to pay off the loan when he caused Bonded to write the check; that if the Bank is a subsequent transferee under Sec. 550(a)(2) it did not give "value" under Sec. 550(b)(1) because Bonded received nothing; and that the Bank loses even if it gave value because it should have known that something was amiss, given the substantial sum Bonded was transferring to a corporate officer. The bankruptcy court granted summary judgment to the Bank without explicitly discussing Sec. 550. The district court affirmed on appeal under 28 U.S.C. Sec. 158(a). It held that the Bank handled the check of January 21 as a "mere conduit" and so was not the initial transferee; that Ryan was the person "for whose benefit the transfer was made" because he got the benefit of the reduction in the balance of the loan; that the Bank's giving value to Ryan satisfied Sec. 550(b)(1); and that because the trustee presented no evidence that the Bank knew or should have known of Bonded's impending collapse, the Bank took in good faith.

If the note accompanying Bonded's check had said: "use this check to reduce Ryan's loan" instead of "deposit this check into [Ryan]'s account", Sec. 550(a)(1) would provide a ready answer. The Bank would be the "initial transferee" and Ryan would be the "entity for whose benefit [the] transfer was made". The trustee could recover the $200,000 from the Bank, Ryan, or both, subject to the rule of Sec. 550(c) that there may be but one recovery. The trustee contends that the apparently formal difference--depositing the check in Ryan's account and then debiting that account--should not affect the outcome. In either case the Bank is the payee of the check and ends up with the money, while Ryan gets the horses free of liens and Bonded is left holding the bag. From a larger perspective, however, the two cases are different.

Fraudulent conveyance law protects creditors from last-minute diminutions of the pool of assets in which they have interests. They accordingly need not monitor debtors so closely, and the savings in monitoring costs make businesses more productive. The original rule, in 13 Eliz. ch. 5 (1571), dealt with debtors who transferred property to their relatives, while the debtors themselves sought sanctuary from creditors. The family enjoyed the value of the assets, which the debtor might reclaim if the creditors stopped pursuing him. In the last 400 years the principle has been generalized to address transfers without either sufficient consideration or bad intent, for they, no less than gifts, reduce the value of the debtor's estate and thus the net return to creditors as a group. The trustee reverses, for the benefit of all creditors, un- or under-compensated conveyances within a specified period before the bankruptcy.

There have always been limits on the pursuit of transfers. If the recipient of a fraudulent conveyance uses the money to buy a Rolls Royce, the auto dealer need not return the money to the bankrupt even if the trustee can identify the serial numbers on the bills. The misfortune of the firm's creditors is not a good reason to mulct the dealer, who gave value for the money and was in no position to monitor the debtor. Some monitoring is both inevitable and desirable, and the creditors are in a better position to carry out this task than are auto dealers and the many others with whom the firm's transferees may deal. . . . Sec. 550(b) leaves with the initial transferee the

burden of inquiry and the risk if the conveyance is fraudulent. The initial transferee is the best monitor; subsequent transferees usually do not know where the assets came from and would be ineffectual monitors if they did.

The potential costs of monitoring and residual risk are evident when the transferees include banks and other financial intermediaries. The check-clearing system processes more than 100 million instruments every day; most pass through several banks as part of the collection process; each bank may be an owner of the instrument or agent for purposes of collecting at a given moment. Some of these instruments represent funds fraudulently conveyed out of bankrupts, yet the cost of checking back on the earlier transferors would be staggering. Bonded's trustee dismisses financial intermediaries on the ground that they obviously are not initial transferees, but this is not so clear. Hundreds of thousands of wire transfers occur every day. The sender of money on a wire transfer tells its bank to send instructions to the Federal Reserve System (for a Fedwire transfer) or to a correspondent bank to make money or credit available through still another bank. The Fed or the receiving bank could be called the "initial transferee" of the funds if we disregarded the function of fraudulent conveyance law. Similarly, an armored car company might be called the "initial transferee" if the bankrupt gave it valuables or specie to carry. Exposing financial intermediaries and couriers to the risk of disgorging a "fraudulent conveyance" in such circumstances would lead them to take precautions, the costs of which would fall on solvent customers without significantly increasing the protection of creditors.

The functions of fraudulent conveyance law lead us to conclude that the Bank was not the "initial transferee" of Bonded's check even though it was the payee. The Bank acted as a financial intermediary. It received no benefit. Ryan's loan was fully secured and not in arrears, so the Bank did not even acquire a valuable right to offset its loan against the funds in Ryan's account. Under the law of contracts, the Bank had to follow the instructions that came with the check. The Uniform Commercial Code treats such instructions as binding to the extent any contract binds (see UCC Sec. 3-119). The Bank therefore was no different from a courier or an intermediary on a wire transfer; it held the check only for the purpose of fulfilling an instruction to make the funds available to someone else.

Although the Bankruptcy Code does not define "transferee", and there is no legislative history on the point, we think the minimum requirement of status as a "transferee" is dominion over the money or other asset, the right to put the money to one's own purposes. When A gives a check to B as agent for C, then C is the "initial transferee"; the agent may be disregarded.

As the Bank saw the transaction on January 21, it was Ryan's agent for the purpose of collecting a check from Bonded's bank. It received nothing from Bonded that it could call its own; the Bank was not Bonded's creditor, and Ryan owed the Bank as much as ever. The Bank had no dominion over the $200,000 until January 31, when Ryan instructed the Bank to debit the account to reduce the loan; in the interim, so far as the Bank was concerned, Ryan was free to invest the whole $200,000 in lottery tickets or uranium stocks. As the Bank saw things on January 31, it was getting Ryan's money. It would be at risk if Ryan were defrauding his other creditors or preferring the Bank, but the Bank would perceive no reason to investigate Bonded or sequester the money for the benefit of Bonded's creditors. So the two-step transaction is indeed different from the one-step transaction we hypothesized at the beginning of this discussion.

We are aware that some courts say that an agent (or a bank in a case like ours) is an "initial transferee" but that courts may excuse the transferee from repaying using equitable powers. This is misleading. "Transferee" is not a self-defining term; it must mean something different from "possessor" or "holder" or "agent". To treat "transferee" as "anyone who touches the money" and then to escape the absurd results that follow is to introduce useless steps; we slice these off with Occam's Razor and leave a more functional rule.

If the Bank is not the "initial transferee", the trustee insists, it is at least the "entity for whose benefit such transfer was made". The Bank ultimately was paid and therefore, one might think, it got the "benefit" of the transfer--though the Bank cancelled the note and gave up a security interest in horses that, the trustee concedes, was sufficient to cover the balance. Kenneth Kortas, Bonded's day-to-day manager, filed an affidavit stating that he prepared the check in question at Ryan's request as part of Ryan's program "to put the horse business in a position where it could function and sustain itself for at least several months even if his other business ventures ran into financial difficulty.... At the request of Ryan, I routinely prepared checks payable to banks where Ryan had personal accounts and loan accounts to finance his horse business." This may show that Ryan intended all along to wash the $200,000 through his personal account and pay the Bank; at a minimum, the argument would run, questions of intent prevent summary judgment.

The Bank responds that it did not "intend" to be the beneficiary of the transfer; it was not in cahoots with Ryan or Bonded and did not know of their plans. Moreover, the Bank insists that it did not receive a "benefit" because it gave value for the $200,000. The only beneficiary on this view was Ryan, who increased his equity position in Shamrock Hill Farm and obtained clear title to the horses. As both initial transferee and ultimate beneficiary, Ryan is the only person covered by Sec. 550(a)(1), the Bank insists. The distinction is important, because entities covered by Sec. 550(a)(1) cannot use the value-and-good-faith defense provided by Sec. 550(b).

This exchange seems to raise difficult questions. To what extent does "intent" matter under Sec. 550(a)(1)? If intent matters, whose? To what extent must courts find the true economic benefits of a transaction? If the Bank were undersecured, would the transfer make the Bank the beneficiary by the amount of the difference between the loan and the security? Suppose Ryan planned to, and did, buy a Rolls Royce with the money; would the dealer be the beneficiary by the difference between the wholesale and retail price of the car? How are bankruptcy courts to determine "intent" and compute the benefit in transactions of this nature?

These questions need not be answered, because a subsequent transferee cannot be the "entity for whose benefit" the initial transfer was made. The structure of the statute separates initial transferees and beneficiaries, on the one hand, from "immediate or mediate transferee[s]", on the other. The implication is that the "entity for whose benefit" is different from a transferee, "immediate" or otherwise. The paradigm "entity for whose benefit such transfer was made" is a guarantor or debtor--someone who receives the benefit but not the money. In the Firm-Guarantor-Lender example at the end of Part I, when Firm pays the loan, Lender is the initial transferee and Guarantor, which no longer is exposed to liability, is the "entity for whose benefit". If Bonded had sent a check to the Bank with instructions to reduce Ryan's loan, the Bank would have been the initial transferee and Ryan the "entity for whose benefit. Section 550(a)(1) recognizes that debtors often pay money to A for the benefit of B; that B may indeed have arranged for the payment (likely so if B is an insider of the payor); that but for the payment B may have had to make good on the guarantee or pay off his own debt; and accordingly that B should be treated the same way initial

recipients are treated. If B gave value to the bankrupt for the benefit, B will receive credit in the bankruptcy, and if not, B should be subject to recovery to the same extent as A--sometimes ahead of A, although Sec. 550 does not make this distinction. Someone who receives the money later on is not an "entity for whose benefit such transfer was made"; only a person who receives a benefit from the initial transfer is within this language.

To say that the categories "transferee" and "entity for whose benefit such transfer was made" are mutually exclusive does not necessarily make it easy to determine in which category a given entity falls. The method we employed in Part I of this opinion to decide that the Bank was not an "initial" transferee governs the question whether entities are subsequent transferees, too. The answer is not difficult in this case, however. The Bank did not obtain a benefit from the transfer to Ryan on January 21; it obtained dominion over the funds on January 31. The Bank is a transferee.

A trustee may not recover from a subsequent transferee who "takes for value, including satisfaction ... of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided", Sec. 550(b)(1). The Bank took for value on January 31. It had extended $655,000 in credit to Ryan, and the payment satisfied $200,000 of this debt; the Bank also released a share of its security interest. Bonded's trustee contends, however, that a subsequent transferee must give value to the debtor; the Bank gave value only to Ryan.

The statute does not say "value to the debtor"; it says "value". A natural reading looks to what the transferee gave up rather than what the debtor received. Other portions of the Code require value to the debtor. Section 548(c), for example, gives the initial recipient of a fraudulent conveyance a lien against any assets it hands back, "to the extent that such transferee ... gave value to the debtor in exchange for such transfer". The difference between "value" in Sec. 550(b)(1) and "value to the debtor" in Sec. 548(c) makes sense. Section 550(b)(1) implements a system well known in commercial law, in which a transferee of commercial paper or chattels acquires an interest to the extent he purchased the items without knowledge of a defect in the chain. These recipients receive protection because monitoring of earlier stages is impractical, and exposing them to risk on account of earlier delicts would make commerce harder to conduct. Benefits to the commercial economy, and not to the initial transferors (who may be victims of fraud), justify this approach.

Transferees and other purchasers generally deal only with the previous person in line; they give value, if at all, to their transferors (or the transferors' designees). The statute emulates the pattern of other rules protecting good faith purchasers. All of the courts that have considered this question have held or implied that value to the transferor is sufficient.

The final question is whether the Bank received the $200,000 "in good faith, and without knowledge of the voidability of the transfer avoided". The trustee does not contend that the Bank knew of Bonded's precarious condition or Ryan's plan to use Bonded's money to pay his personal debts. He does not say that the Bank acted in bad faith--or even that there is a difference between "good faith" and "without knowledge of the voidability of the transfer".

The phrase "good faith" in [Sec. 550(b)] is intended to prevent a transferee from whom the trustee could recover from transferring the recoverable property to an innocent transferee, and receiving a transfer from him, that is, "washing" the transaction through an innocent third party.

In order for the transferee to be excepted from liability ... he himself must be a good faith transferee.

The trustee contends, instead, that the Bank should have known about Bonded's distress and Ryan's chicanery; had it investigated the deposit on January 21, it would have found out; and because it should have known, this is as good as knowledge.

Imputed knowledge is an old idea, employed even in the criminal law. Venerable authority has it that the recipient of a voidable transfer may lack good faith if he possessed enough knowledge of the events to induce a reasonable person to investigate. No one supposes that "knowledge of voidability" means complete understanding of the facts and receipt of a lawyer's opinion that such a transfer is voidable; some lesser knowledge will do. Some facts strongly suggest the presence of others; a recipient that closes its eyes to the remaining facts may not deny knowledge. But this is not the same as a duty to investigate, to be a monitor for creditors' benefit when nothing known so far suggests that there is a fraudulent conveyance in the chain. "Knowledge" is a stronger term than "notice". A transferee that lacks the information necessary to support an inference of knowledge need not start investigating on his own.

Nothing in the record of this case suggests that the Bank knew of Bonded's financial peril or Ryan's plan. Bonded was not the Bank's customer. The transfer from Ryan to the Bank on January 31 was innocuous. The Bank thought it got Ryan's money; its loan was fully secured; it perceived Ryan as a well-heeled horse breeder, with a balance sheet in the millions, current on his loan payments.

The transfer from Bonded to Ryan on January 21 was only slightly more problematic from the Bank's perspective. A corporation was transferring $200,000 to one of its executives. This does not hint at a fraudulent conveyance by a firm on the brink of insolvency; for all the Bank knew, Bonded had plenty more where the $200,000 came from. Banks frequently receive large checks from corporations to their officers; think of the annual bonus checks General Motors issues, or the check to repurchase a bloc of shares. A $200,000 check is not a plausible bonus for a currency exchange, however. It could hint at embezzlement. Several Illinois cases say that a bank should inquire when a firm's employee signs a large check with himself as payee.

Since those cases were decided, Illinois adopted the Uniform Fiduciaries Act, which relieves banks of such a duty to inquire into the authority of the fiduciary signing the check on the maker's behalf. At all events, the Bank had no reason to think Ryan an embezzler. The check was accompanied by a memorandum from Kenneth Kortas, Bonded's manager, demonstrating that Ryan was not keeping other corporate officers in the dark. The Kortas memorandum would have led a reasonable bank to conclude that Bonded as a corporate entity wanted to make the transfer--and a bank drawing that inference here would have been right. Had the Bank called Kortas (or anyone else at Bonded) to inquire about the check, the Bank would have learned that the instrument was authorized by the appropriate corporate officials. Since the inquiry would have turned up nothing pertinent to voidability, the Bank's failure to make it does not permit a court to attribute to it the necessary knowledge.

The Bank is a subsequent transferee covered by Sec. 550(b)(1). It took for value and without knowledge of the voidability of the initial transaction.

8.25.2. KELLOGG v. BLUE QUAIL ENERGY, 831 F.2d 586 (5th Cir. 1987)

In March 1982, Blue Quail Energy, Inc., delivered a shipment of oil to debtor Compton Corporation. Payment of $585,443.85 for this shipment of oil was due on or about April 20, 1982. Compton failed to make timely payment. Compton induced MBank-Abilene National Bank to issue an irrevocable standby letter of credit in Blue Quail's favor on May 6, 1982. Under the terms of the letter of credit, payment of up to $585,443.85 was due Blue Quail if Compton failed to pay Blue Quail this amount by June 22, 1982. Compton paid MBank $1,463.61 to issue the letter of credit. MBank also received a promissory note payable on demand for $585,443.85. MBank did not need a security agreement to cover the letter of credit transaction because a prior 1980 security agreement between the bank and Compton had a future advances provision. This 1980 security agreement had been perfected as to a variety of Compton's assets through the filing of several financing statements. The most recent financing statement had been filed a year before, May 7, 1981. The letter of credit on its face noted that it was for an antecedent debt due Blue Quail.

On May 7, 1982, the day after MBank issued the letter of credit in Blue Quail's favor, several of Compton's creditors filed an involuntary bankruptcy petition against Compton. On June 22, 1982, MBank paid Blue Quail $569,932.03 on the letter of credit after Compton failed to pay Blue Quail.

In the ensuing bankruptcy proceeding, MBank's aggregate secured claims against Compton, including the letter of credit payment to Blue Quail, were paid in full from the liquidation of Compton's assets which served as the bank's collateral. Walter Kellogg, bankruptcy trustee for Compton, did not contest the validity of MBank's secured claim against Compton's assets for the amount drawn under the letter of credit by Blue Quail. Instead, on June 14, 1983, trustee Kellogg filed a complaint in the bankruptcy court against Blue Quail asserting that Blue Quail had received a preferential transfer under 11 U.S.C. Sec. 547 through the letter of credit transaction. The trustee sought to recover $585,443.85 from Blue Quail pursuant to 11 U.S.C. Sec. 550.

Blue Quail answered and filed a third party complaint against MBank. [The Bankruptcy Court granted Blue Quail's] motion for summary judgment, [holding] that the trustee could not recover any preference from Blue Quail because Blue Quail had been paid from MBank's funds under the letter of credit and therefore had not received any of Compton's property. The district court affirmed, [holding] that the transfer of the increased security interest to MBank was a transfer of the debtor's property for the sole benefit of the bank and in no way benefitted Blue Quail.

It is well established that a letter of credit and the proceeds therefrom are not property of the debtor's estate under 11 U.S.C. Sec. 541. When the issuer honors a proper draft under a letter of credit, it does so from its own assets and not from the assets of its customer who caused the letter of credit to be issued. As a result, a bankruptcy trustee is not entitled to enjoin a post petition payment of funds under a letter of credit from the issuer to the beneficiary, because such a payment is not a transfer of debtor's property (a threshold requirement under 11 U.S.C. Sec. 547(b)). A case apparently holding otherwise, *In re Twist Cap., Inc.*, 1 B.R. 284 (Bankr. Fla. 1979), has been roundly criticized and otherwise ignored by courts and commentators alike.

Recognizing these characteristics of a letter of credit in a bankruptcy case is necessary in order to maintain the independence principle, the cornerstone of letter of credit law. Under the independence principle, an issuer's obligation to the letter of credit's beneficiary is independent from any obligation between the beneficiary and the issuer's customer. All a beneficiary has to do to receive payment under a letter of credit is to show that it has performed all the duties required by the letter of credit. Any disputes between the beneficiary and the customer do not affect the issuer's obligation to the beneficiary to pay under the letter of credit.

Letters of credit are most commonly arranged by a party who benefits from the provision of goods or services. The party will request a bank to issue a letter of credit which names the provider of the goods or services as the beneficiary. Under a standby letter of credit, the bank becomes primarily liable to the beneficiary upon the default of the bank's customer to pay for the goods or services. The bank charges a fee to issue a letter of credit and to undertake this liability. The shifting of liability to the bank rather than to the services or goods provider is the main purpose of the letter of credit. After all, the bank is in a much better position to assess the risk of its customer's insolvency than is the service or goods provider. It should be noted, however, that it is the risk of the debtor's insolvency and not the risk of a preference attack that a bank assumes under a letter of credit transaction. Overall, the independence principle is necessary to insure "the certainty of payments for services or goods rendered regardless of any intervening misfortune which may befall the other contracting party."

The trustee in this case accepts this analysis and does not ask us to upset it. The trustee is not attempting to set aside the postpetition payments by MBank to Blue Quail under the letter of credit as a preference; nor does the trustee claim the letter of credit itself constitutes debtor's property. **The trustee is instead challenging the earlier transfer in which Compton granted MBank an increased security interest in its assets to obtain the letter of credit for the benefit of Blue Quail**. Collateral which has been pledged by a debtor as security for a letter of credit is property of the debtor's estate. The trustee claims that the direct transfer to MBank of the increased security interest on May 6, 1982, **also constituted an indirect transfer to Blue Quail** which occurred one day prior to the filing of the involuntary bankruptcy petition and is voidable as a preference under 11 U.S.C. Sec. 547.

It is important to note that the irrevocable standby letter of credit in the case at bar was not arranged in connection with Blue Quail's initial decision to sell oil to Compton on credit. Compton arranged for the letter of credit after Blue Quail had shipped the oil and after Compton had defaulted in payment. The letter of credit in this case did not serve its usual function of backing up a contemporaneous credit decision, but instead served as a backup payment guarantee on an extension of credit already in jeopardy. The letter of credit was issued to pay off an antecedent unsecured debt. This fact was clearly noted on the face of the letter of credit. Blue Quail, the beneficiary of the letter of credit, did not give new value for the issuance of the letter of credit by MBank on May 6, 1982, or for the resulting increased security interest held by MBank. MBank, however, did give new value for the increased security interest it obtained in Compton's collateral: the bank issued the letter of credit.

When a debtor pledges its assets to secure a letter of credit, a transfer of debtor's property has occurred under the provisions of 11 U.S.C. Sec. 547. By subjecting its assets to MBank's reimbursement claim in the event MBank had to pay on the letter of credit, Compton made a transfer of its property. The broad definition of "transfer" under 11 U.S.C. Sec. 101(50) is clearly

designed to cover such a transfer. Overall, the letter of credit itself and the payments thereunder may not be property of debtor, but the collateral pledged as a security interest for the letter of credit is.

Furthermore, in a secured letter of credit transaction, the transfer of debtor's property takes place at the time the letter of credit is issued (when the security interest is granted) and received by the beneficiary, not at the time the issuer pays on the letter of credit.

The transfer to MBank of the increased security interest was a direct transfer which occurred on May 6, 1982, when the bank issued the letter of credit. Under 11 U.S.C. Sec. 547(e)(2)(A), however, such a transfer is deemed to have taken place for purposes of 11 U.S.C. Sec. 547 at the time such transfer "takes effect" between the transferor and transferee if such transfer is perfected within 10 days [**note now 30 days]**. The phrase "takes effect" is undefined in the Bankruptcy Code, but under Uniform Commercial Code Article 9 law, a transfer of a security interest "takes effect" when the security interest attaches. Because of the future advances clause in MBank's 1980 security agreement with Compton, the attachment of the MBank's security interest relates back to May 9, 1980, the date the security agreement went into effect. The bottom line is that the direct transfer of the increased security interest to MBank is artificially deemed to have occurred at least by May 7, 1981, the date MBank filed its final financing statement, for purposes of a preference attack against the bank. This date is well before the 90 day window of 11 U.S.C. Sec. 547(b)(4)(A). This would protect the bank from a preference attack by the trustee even if the bank had not given new value at the time it received the increased security interest. MBank is therefore protected from a preference attack by the trustee for the increased security interest transfer under either of two theories: under 11 U.S.C. Sec. 547(c)(1) because it gave new value and under the operation of the relation back provision of 11 U.S.C. Sec. 547(e)(2)(A). The bank is also protected from any claims of reimbursement by Blue Quail because the bank received no voidable preference.

The relation back provision of 11 U.S.C. Sec. 547(e)(2)(A), however, applies only to the direct transfer of the increased security interest to MBank. The indirect transfer to Blue Quail that allegedly resulted from the direct transfer to MBank occurred on May 6, 1982, the date of issuance of the letter of credit. The relation back principle of 11 U.S.C. Sec. 547(e)(2)(A) does not apply to this indirect transfer to Blue Quail. Blue Quail was not a party to the security agreement between MBank and Compton. So it will not be able to utilize the relation back provision if it is deemed to have received an indirect transfer resulting from the direct transfer of the increased security interest to MBank. Blue Quail, therefore, cannot assert either of the two defenses to a preference attack which MBank can claim. Blue Quail did not give new value under Sec. 547(c)(1), and it received a transfer within 90 days of the filing of Compton's bankruptcy petition.

The federal courts have long recognized that "[t]o constitute a preference, it is not necessary that the transfer be made directly to the creditor. If the bankrupt has made a transfer of his property, the effect of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it." To combat such circuity, the courts have broken down certain transfers into two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party.

This is the situation presented in the case before us. The term "transfer" as used in the various bankruptcy statutes through the years has always been broad enough to cover such indirect transfers and to catch various circuitous arrangements. The new Bankruptcy Code implicitly adopts this doctrine through its broad definition of "transfer." [The Court then reviews other cases involving indirect transfers.]

Blue Quail's attempt to otherwise distinguish the case from the direct/indirect transfer cases does not withstand scrutiny. [In other letter of credit cases], the letters of credit were issued contemporaneously with the initial extension of credit by the beneficiaries of the letters. In those cases the letters of credit effectively served as security devices for the benefit of the creditor beneficiaries and took the place of formal security interests. The courts in those cases properly found there had been no voidable transfers, direct or indirect, in the letter of credit transactions involved. **New value was given contemporaneously with the issuance of the letters of credit in the form of the extensions of credit by the beneficiaries of the letters**. As a result, the 11 U.S.C. Sec. 547(c)(1) preference exception was applicable.

The case at bar differs from these other letter of credit cases by one very important fact: **the letter of credit in this case was issued to secure an antecedent unsecured debt** due the beneficiary of the letter of credit. The unsecured creditor beneficiary gave no new value upon the issuance of the letter of credit. When the issuer paid off the letter of credit and foreclosed on the collateral securing the letter of credit, a preferential transfer had occurred. An unsecured creditor was paid in full and a secured creditor was substituted in its place.

The district court upheld the bankruptcy court in maintaining the validity of the letter of credit issued to cover the antecedent debt. The district court held that MBank, the issuer of the letter of credit, could pay off the letter of credit and foreclose on the collateral securing it. We are in full agreement. But we also look to the impact of the transaction as it affects the situation of Blue Quail in the bankrupt estate. We hold that the bankruptcy trustee can recover from Blue Quail, the beneficiary of the letter of credit, because Blue Quail received an indirect preference. This result preserves the sanctity of letter of credit and carries out the purposes of the Bankruptcy Code by avoiding a preferential transfer. MBank, the issuer of the letter of credit, being just the intermediary through which the preferential transfer was accomplished, completely falls out of the picture and is not involved in this particular legal proceeding.

MBank did not receive any preferential transfer--it gave new value for the security interest. Furthermore, because the direct and indirect transfers are separate and independent, the trustee does not even need to challenge the direct transfer of the increased security interest to MBank, or seek any relief at all from MBank, in order to attack the indirect transfer and recover under 11 U.S.C. Sec. 550 from the indirect transferee Blue Quail.

We hold that a creditor cannot secure payment of an unsecured antecedent debt through a letter of credit transaction when it could not do so through any other type of transaction. The purpose of the letter of credit transaction in this case was to secure payment of an unsecured antecedent debt for the benefit of an unsecured creditor. This is the only proper way to look at such letters of credit in the bankruptcy context. The promised transfer of pledged collateral induced the bank to issue the letter of credit in favor of the creditor. The increased security interest held by the bank clearly benefitted the creditor because the bank would not have issued the letter of credit

without this security. A secured creditor was substituted for an unsecured creditor to the detriment of the other unsecured creditors.

We also hold, therefore, that the trustee can recover under 11 U.S.C. Sec. 550(a)(1) the value of the transferred property from "the entity for whose benefit such transfer was made." In the case at bar, this entity was the creditor beneficiary, not the issuer, of the letter of credit even though the issuer received the direct transfer from the debtor. The entire purpose of the direct/indirect doctrine is to look through the form of a transaction and determine which entity actually benefitted from the transfer.

The fact that there was a prior security agreement between the issuing bank and the debtor containing the future advances clause does not alter this conclusion. As we pointed out in Part II supra, this prior security agreement gave MBank an additional shield from preferential attack because of the relation back mechanism of 11 U.S.C. Sec. 547(e)(2)(A). 11 U.S.C. Sec. 547(e)(2)(A), however, does not avail Blue Quail to shield it from a preferential attack for the indirect transfer. The indirect transfer to Blue Quail occurred on May 6, 1982, when the letter of credit was issued and the increased security interest was pledged. This was the day before the involuntary bankruptcy petition was filed. For purposes of 11 U.S.C. Sec. 547, a transfer of Compton's property for the benefit of Blue Quail did occur within 90 days of the bankruptcy filing. The bankruptcy and district courts erred in failing to analyze properly the transfer of debtor's property that occurred when Compton pledged its assets to obtain the letter of credit. This transfer consisted of two aspects: the direct transfer to MBank which is not a voidable preference for various reasons and the indirect transfer to Blue Quail which is a voidable preference.

The precise holding in this case needs to be emphasized. We do not hold that payment under a letter of credit, or even a letter of credit itself, constitute preferential transfers under 11 U.S.C. Sec. 547(b) or property of a debtor under 11 U.S.C. Sec. 541. The holding of this case fully allows the letter of credit to function. We preserve its sanctity and the underlying independence doctrine. We do not, however, allow an unsecured creditor to avoid a preference attack by utilizing a letter of credit to secure payment of an antecedent debt. Otherwise the unsecured creditor would receive an indirect preferential transfer from the granting of the security for the letter of credit to the extent of the value of that security. Our holding does not affect the strength of or the proper use of letters of credit. When a letter of credit is issued contemporaneously with a new extension of credit, the creditor beneficiary will not be subject to a preferential attack under the direct/indirect doctrine elaborated in this case because the creditor will have given new value in exchange for the indirect benefit of the secured letter of credit. Only when a creditor receives a secured letter of credit to cover an unsecured antecedent debt will it be subject to a preferential attack under 11 U.S.C. Sec. 547(b).

Blue Quail has no valid claim against MBank for reimbursement for any amounts Blue Quail has to pay the trustee under the trustee's preference claim, just as the trustee has no preference challenge against MBank. Blue Quail received the preferential transfer, not MBank. MBank gave new value in exchange for the increased security interest in its favor. Thus, it is insulated from any assertion of a voidable preference. The bank in no way assumed the risk of a preference attack by issuing the letter of credit. For these reasons, we affirm the district court's dismissal of Blue Quail's request to proceed against MBank for reimbursement.

In addition, the trustee may not set aside the $1,463.61 fee Compton paid MBank to issue the letter of credit. This payment is not a preferential transfer. MBank has fully performed its duties under the terms of the letter of credit and has earned this fee. The services MBank rendered in issuing and executing the letter of credit constitute new value under the 11 U.S.C. Sec. 547(c)(1) preference exception.

8.26. Practice Problems: The Debtor's Avoiding Powers

Problem 1. Debtor repays a $10,000 loan ten days before filing bankruptcy. The trustee avoids the transfer as a preference under Section 547 and recovers $10,000 from the creditor under Section 550. The Debtor has not used $15,000 of her wild card exemption. Can the Debtor exempt the trustee's recovery and keep the $10,000? 11 U.S.C. § 522(g).

Problem 2. Creditor garnishes $10,000 of the Debtor's wages during the 90 day period prior to bankruptcy. The trustee brings a preference action under Section 547 to avoid the $10,000 transfer, and recovers $10,000 from the creditor under Section 550. The debtor has not used $20,000 of her wild card exemption. Can the Debtor exempt the trustee's recovery and keep the $10,000? 11 U.S.C. § 522(g).

Problem 3. Suppose that the Trustee in Problem (2), recognizing the futility of seeking to avoid and recover the $10,000 decides not to bring a preference action. Can the Debtor bring the action? 11 U.S.C. § 522(h).

Chapter 9. Secured Claims in Bankruptcy

9.1. The Section 506(a) Split

Section 506 is an extremely important provision of the Bankruptcy Code and should be read with great care. It begins with a fundamental concept: a creditor whose collateral is worth less than the debt is partially secured, and partially unsecured. 11 U.S.C. § 506(a). The undersecured creditor thus has two claims in bankruptcy that are treated very differently: a secured claim to the extent of the value of the collateral, and an unsecured claim for the potential deficiency.

Section 506(a) also discusses how the collateral should be valued for purposes of the split. Originally, the value was governed by the last sentence of Section 506(a) – the collateral should be valued "in light of the purpose of the valuation and proposed disposition and use of the property." Thus, the valuation could change throughout the case depending on why the collateral was being valued. In *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), reprinted below, the Supreme Court established a replacement value standard for reorganization cases where the debtor sought to keep the collateral. It is important to note the famous footnote 4 from the *Rash* decision, which remains a correct and important consideration in the valuation process.

In 2005, Congress added section 506(a)(2) to the Bankruptcy Code. The general rule of section 506(a)(2) follows *Rash*, but the new statute differs from Rash in the case of **consumer goods** by requiring the use of **retail value**. The statute thus makes it more difficult for debtors to keep their consumer goods even though the creditor will not be able to recover retail value after repossession.

The creditors who pushed for section 506(a)(2)'s overvaluation may not have fully thought the situation through. If the rule makes it more difficult for debtors to keep their property by requiring the use of a high retail value, what happens when the debtors throw up their hands and surrender the collateral back to the secured creditor? The case that follows *Rash* in the materials, *In re Brown*, proves the old adage: "what is sauce for the goose is sauce for the gander."

9.2. Cases on Valuation and the Section 506(a) Split

9.2.1. ASSOCIATES COMMERCIAL v. RASH, 520 U.S. 953 (1997)

JUSTICE GINSBURG

In 1989, respondent Elray Rash purchased for $73,700 a Kenworth tractor truck for use in his freight-hauling business. Rash made a down payment on the truck, agreed to pay the seller the remainder in 60 monthly installments, and pledged the truck as collateral on the unpaid balance. The seller assigned the loan, and its lien on the truck, to petitioner Associates Commercial Corporation (ACC).

In March 1992, Elray and Jean Rash filed a joint petition and a repayment plan under Chapter 13. At the time of the bankruptcy filing, the balance owed to ACC on the truck loan was $41,171. Because it held a valid lien on the truck, ACC was listed in the bankruptcy petition as a

creditor holding a secured claim. Under the Code, ACC's claim for the balance owed on the truck was secured only to the extent of the value of the collateral; its claim over and above the value of the truck was unsecured.

The Rashes' Chapter 13 plan invoked the cram down power. It proposed that the Rashes retain the truck for use in the freight-hauling business and pay ACC, over 58 months, an amount equal to the present value of the truck. That value, the Rashes' petition alleged, was $28,500. ACC objected to the plan and asked the Bankruptcy Court to lift the automatic stay so ACC could repossess the truck. ACC also filed a proof of claim alleging that its claim was fully secured in the amount of $41,171. The Rashes filed an objection to ACC's claim.

The Bankruptcy Court held an evidentiary hearing to resolve the dispute over the truck's value. At the hearing, ACC and the Rashes urged different valuation benchmarks. ACC maintained that the proper valuation was the price the Rashes would have to pay to purchase a like vehicle, an amount ACC's expert estimated to be $41,000. The Rashes, however, maintained that the proper valuation was the net amount ACC would realize upon foreclosure and sale of the collateral, an amount their expert estimated to be $31,875.

Courts of Appeals have adopted three different standards for valuing a security interest in a bankruptcy proceeding when the debtor invokes the cram down power to retain the collateral over the creditor's objection. In contrast to the Fifth Circuit's foreclosure-value standard, a number of Circuits have followed a replacement-value approach. Other courts have settled on the midpoint between foreclosure value and replacement value. We granted certiorari to resolve this conflict.

Over ACC's objection, the Rashes' repayment plan proposed, pursuant to § 1325(a)(5)(B), continued use of the property in question, i. e., the truck, in the debtor's trade or business. In such a "cram down" case, we hold, the value of the property (and thus the amount of the secured claim under § 506(a)) is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller. . . .

The second sentence of § 506(a) does speak to the how question. "Such value," that sentence provides, "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." § 506(a). By deriving a foreclosure-value standard from § 506(a)'s first sentence, the Fifth Circuit rendered inconsequential the sentence that expressly addresses how "value shall be determined."

As we comprehend § 506(a), the "proposed disposition or use" of the collateral is of paramount importance to the valuation question. If a secured creditor does not accept a debtor's Chapter 13 plan, the debtor has two options for handling allowed secured claims: surrender the collateral to the creditor, or, under the cram down option, keep the collateral over the creditor's objection and provide the creditor, over the life of the plan, with the equivalent of the present value of the collateral. The "disposition or use" of the collateral thus turns on the alternative the debtor chooses - in one case the collateral will be surrendered to the creditor, and in the other, the collateral will be retained and used by the debtor. Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor's choice to surrender the property or retain it. A replacement-value standard, on the other hand, distinguishes retention from surrender and renders meaningful the key words "disposition or use."

Tying valuation to the actual "disposition or use" of the property points away from a foreclosure-value standard when a Chapter 13 debtor, invoking cram down power, retains and uses

the property. Under that option, foreclosure is averted by the debtor's choice and over the creditor's objection. From the creditor's perspective as well as the debtor's, surrender and retention are not equivalent acts.

When a debtor surrenders the property, a creditor obtains it immediately, and is free to sell it and reinvest the proceeds. We recall here that ACC sought that very advantage. If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more "adequate protection" do not fully offset these risks.

Of prime significance, the replacement-value standard accurately gauges the debtor's "use" of the property. It values "the creditor's interest in the collateral in light of the proposed [repayment plan] reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to ... its [replacement] value." The debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's "disposition or use."

As our reading of § 506(a) makes plain, we also reject a ruleless approach allowing use of different valuation standards based on the facts and circumstances of individual cases. We agree with the Seventh Circuit that "a simple rule of valuation is needed" to serve the interests of predictability and uniformity. We conclude, however, that § 506(a) supplies a governing instruction less complex than the Seventh Circuit's "make two valuations, then split the difference" formulation.

In sum, under § 506(a), the value of property retained because the debtor has exercised the § 1325(a)(5)(B) "cram down" option is the cost the debtor would incur to obtain a like asset for the same "proposed ... use."[3]

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[3] Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. Cf. 90 F.3d, at 1051-1052. Nor should the creditor gain from modifications to the property-e. g., the addition of accessories to a vehicle-to which a creditor's lien would not extend under state law.

9.2.2. IN RE BROWN, 746 F.3d 1236 (11th Cir. 2014)

The issue before this Court is whether § 506(a)(2)'s valuation standard applies when a Chapter 13 debtor surrenders his vehicle under § 1325(a)(5)(C). We hold that it does, and we affirm.

In July 2007, Brown purchased a 37-foot 2006 Keystone Challenger recreational vehicle. Brown entered into a loan agreement secured by the recreational vehicle. In July 2012, Brown filed for Chapter 13 bankruptcy. Santander, the owner of the loan agreement, filed a proof of secured claim in the bankruptcy court for $36,587.53, the outstanding payoff balance due at the petition date. Brown's modified Chapter 13 plan proposed surrendering the vehicle in full satisfaction of Santander's claim. Santander objected to the confirmation of the plan.

At the confirmation hearing on September 27, 2012, the parties disagreed on the method for valuing Brown's vehicle. Brown argued that § 506(a)(2)'s replacement value standard governed his vehicle's valuation, which in turn determined the amount of Santander's secured claim. Brown contended that if his vehicle's replacement value exceeded his debt, surrendering his vehicle would satisfy Santander's entire claim (and his debt). Santander argued that a surrendered vehicle's value should be based on its foreclosure value, not replacement value.

The bankruptcy court found that while the Supreme Court's 1997 decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), supported applying a foreclosure value standard to Brown's surrendered vehicle, Rash preceded the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005's ("BAPCPA") addition of § 506(a)(2), which required the replacement value standard. The court concluded Santander would have a secured claim to the extent of the vehicle's replacement value, and that Brown's surrender of the vehicle would satisfy that claim under § 1325(a)(5)(C).

Following a valuation and confirmation hearing, the bankruptcy court determined that the vehicle's replacement value at least equaled the debt and confirmed Brown's Chapter 13 plan.[

In Rash, the debtor proposed to retain the collateral under § 1325(a)(5)(B), while valuing the collateral based on its foreclosure value. However, the Supreme Court interpreted "disposition or use" as requiring different valuation standards depending on whether the collateral was surrendered or retained. Rash held that the proper standard was replacement value, not foreclosure value, in the retention context.

After Rash, BAPCPA added § 506(a)(2). Like § 506(a)(1)'s last sentence, § 506(a)(2) refers to § 506(a)(1)'s bifurcation provision and addresses how to determine value. Unlike § 506(a)(1), § 506(a)(2)'s scope is limited to certain cases and expressly mandates a replacement value standard. . . . Thus, when § 506(a)(1) and (a)(2) both apply, a creditor holding an undersecured claim would have a secured claim equal to the collateral's judicially-determined replacement value and an unsecured claim to the extent the debt exceeds the collateral's replacement value.

The parties do not dispute that Brown is an individual in a Chapter 13 case with property falling within the scope of § 506(a)(2). Nevertheless, they dispute whether § 506(a)(2) applies. Santander contends § 506(a)(2)'s replacement value standard does not apply where, as here, the debtor exercises the surrender option under § 1325(a)(5)(C). Brown contends it does.

We begin with the text of the Bankruptcy Code. . . .

We disagree with Santander's textual arguments. Santander argues that applying § 506(a)(2)'s replacement value standard when a debtor surrenders property under § 1325(a)(5)(C) would misapply *Rash* and violate § 506(a)(1)'s "disposition and use" language. Specifically, Santander contends that applying a replacement value standard would ignore *Rash's* holding that different valuation standards should apply depending on the collateral's "disposition or use," with foreclosure value governing surrender and replacement value governing retention.

But Santander fails to acknowledge that Rash preceded BAPCPA's addition of § 506(a)(2), which expressly requires applying the replacement value standard in this case. And while § 506(a)(2)'s replacement value standard mandate seemingly contradicts § 506(a)(1)'s broader "disposition and use" valuation language, a well-established canon "of statutory construction [is] that the specific governs the general."

Here, § 506(a)(2) specifies how to value certain property in Chapter 7 and 13 cases, while § 506(a)(1) is more broadly worded and says nothing about Chapter 7 and 13 cases. When a case falls within § 506(a)(2)'s ambit, its specific requirements control.

Santander's corollary argument is that § 506(a)(2) only applies to cases where the debtor exercises the retention option under § 1325(a)(5)(B). But this requires us to read a limitation into the statute that does not exist in the plain text. Congress expressly limited § 506(a)(2) to certain Chapter 7 and 13 cases; it could have also limited § 506(a)(2) to cases where the debtor retains or "uses" the collateral. Congress did not, and neither will we.

Santander also asserts that § 506(a)(2) only applies to retained property under § 1325(a)(5)(B), because BAPCPA only added § 506(a)(2) to codify Rash's holding that replacement value should govern in the retention context. We acknowledge that cases have described § 506(a)(2) as a codification of *Rash*, but they do not hold that § 506(a)(2) is limited to the facts of *Rash*. Nor does the text of § 506(a)(2) support that conclusion.

Santander also suggests that it is improper to conduct any valuation at all, because Rash "does not state that the court is to pre-determine the value of surrendered vehicles under § 506(a) based on foreclosure value, or any other value standard." However, as Santander concedes, § 506(a)(1) bifurcation applies. Because bifurcation is premised on the collateral's valuation, "[i]t was permissible for [Brown] to seek a valuation in proposing [his] Chapter 13 plan."

Nor are we persuaded by Santander's arguments that applying § 506(a)(2) in the surrender context would be absurd. Santander argues that it would be absurd because it allows debtors to surrender collateral in full satisfaction of the debt. This overstates the effect of § 506(a)(2). Surrender would satisfy the creditor's secured claim, not the entire debt. If a creditor holds an undersecured claim, the creditor would still have an unsecured claim to the extent the debt exceeds the collateral's judicially-determined replacement value.

Santander also argues that applying § 506(a)(2) would be absurd because it eliminates creditors' contract and state law rights to liquidate and pursue an unsecured claim for any deficiency. But state law does not govern if the Bankruptcy Code requires a different result. Here, the Bankruptcy Code is contrary to state law, as an unsecured claim under § 506(a)(1) and (a)(2) equals the amount that the debt exceeds the property's replacement value — not the amount of post-sale deficiency. Thus, state law cannot apply.

The district court's order affirming the bankruptcy court is AFFIRMED.

9.3. Practice Problems: The 506(a) Split

Problem 1. Debtor bought a new car for $25,000 last year, financing 100% of the purchase price at an 18% annual interest rate. The Debtor does not use the car for business, but uses it to get to work. The Debtor currently owes $24,500 on the car. The car has a liquidation value of $8,000, a replacement value of $12,000, and would be sold by a dealer for $18,000 with the standard 30 day warranty required by New York law for retail sales. What claims should the lender have? Does it make any difference for valuation whether the Debtor wants to keep or surrender the car?

Problem 2. Would your answer change if the Debtor used the car in his business as a traveling salesperson?

Problem 3. What if the Debtor that owned the car was a corporation?

Problem 4. Debtor owns a home that is subject to a first lien for unpaid property taxes of $12,000, a first mortgage of $100,000, and a second mortgage of $20,000. What claims do the creditors have if the property is worth $85,000, $113,000, or $150,000? Does it matter whether the debtor is keeping or surrendering the home?

Problem 5. Creditor made a $1 million loan to the debtor prepetition secured by the Debtor's office building. After a hearing, the bankruptcy court determined that the office building had a fair market value of $600,000, and therefore that the Creditor had a $600,000 secured claim and a $400,000 unsecured claim. Thereafter, the trustee received an offer of $800,000 for the property. Can the trustee sell the property for $800,000, pay off the secured claim of $600,000, and keep the $200,000 balance for unsecured creditors?

Problem 6. If Creditor in Problem (5) believes that the property is worth $900,000, is there anything that Creditor can do in connection with the proposed sale to preserve its rights as a secured creditor? *See* 11 U.S.C. § 363(k).

9.4. Practice Problems: Post-Petition Interest, Fees, Costs and Charges (11 U.S.C. § 506(b))

Read Section 506(b) carefully and answer the following problems:

Problem 1. On the petition date, Debtor owns a house worth $210,000, and owes $200,000 in principal on a first mortgage. The mortgage carries a simple interest rate of 1% per month. The promissory note also provides for late fees of an additional 1% of the loan balance per month during any period of default. The debtor does not have the money to make mortgage payments. Assume that the debtor files bankruptcy exactly one month after the last payment was made. What claims does the lender have on the petition date, and what claims will the lender have three months later? 12 months later?

Problem 2. Same as Problem (1) except the Debtor owns a house worth 200,000, and the principal balance on the first mortgage is $210,000 on the petition date. What claims does the lender have on the petition date, and what claims will the lender have three months later? 12 months later?

Problem 3. Can the interest rate on a loan be challenged on the grounds that the rate is unreasonably high? Can the late charge provision be challenged in bankruptcy?

9.5. Cases on Post-Petition Interest under § 506(b)

9.5.1. IN RE RESIDENTIAL CAPITAL, INC., 508 B.R. 851 (Bankr. S.D.N.Y. 2014)

The Bankruptcy Code entitles oversecured creditors to postpetition interest, but the Code does not describe how to calculate it. As an oversecured creditor, Citibank seeks postpetition interest at the default rate governed by its contract (the "Agreement") with two Debtor entities.

The ResCap Liquidating Trust (the "Trust") opposes the contract default rate, arguing that it is inequitable because it would harm unsecured creditors and because Citibank was protected in the bankruptcy and was adequately compensated both before and during the bankruptcy. The parties agree that the right to postpetition interest does not arise from the contract itself; the right arises from the Bankruptcy Code. The parties have stipulated to the facts and seek a decision without the necessity of an evidentiary hearing.

In determining the interest to be awarded to an oversecured creditor, two guiding principles apply: (1) courts in this circuit apply a rebuttable presumption that the contract default rate applies; and (2) a court has only limited discretion—which it should exercise "sparingly"— to modify the contract interest rate. Case law has identified non-exclusive factors to consider in exercising this discretion. The factors do not all point in one direction here. For the reasons explained below, the Court concludes that Citibank should recover postpetition interest at the contract default rate, but only after the loan's maturity date. For the period between the Debtors' bankruptcy filings and the loan's maturity date, interest at the contract non-default interest rate—already paid to Citibank—is appropriate.

Citibank also seeks to recover the unpaid portion of its legal fees and expenses in pursuing default interest at the contract rate. The Agreement provides that Citibank is entitled to recover its fees and expenses, most of which were paid by the Debtors during the case; at some point the Debtors stopped paying, so Citibank now seeks to recover the unpaid balance. Because Citibank's Motion was pursued in good faith, its request to recover attorneys' fees and expenses that were not previously reimbursed is GRANTED, subject to the Trust having an opportunity to review and challenge the reasonableness of the requested fees and expenses.

On May 14, 2012 (the "Petition Date"), each of the Debtors filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code. Before the Petition Date, Citibank entered into a revolving credit facility with GMAC Mortgage, LLC ("GMACM") as borrower and Residential Capital, LLC ("ResCap") as guarantor. That MSR Loan Facility allowed GMACM to borrow up to $700 million, secured by mortgage servicing rights ("MSRs") for loans in Fannie Mae and Freddie Mac securitization pools.

Originally, the MSR Loan Facility had a maturity date of August 31, 2010 (id. ¶ 7), but the parties amended the Agreement ten times, [the last time in contemplation of bankruptcy]. If, as the parties contemplated, bankruptcy petitions were filed, they understood the loans would probably

not be repaid at maturity, but agreed that any order approving the sale of the collateral "shall provide for the repayment of Loans with proceeds of Collateral received by the Borrower from such sale . . . ." (Id.) The substantial extension fee for Amendment Ten no doubt recognized that the loans in all likelihood were going to remain outstanding for more than two months while the Debtors marketed their assets and obtained necessary approvals for the sales (including from the Court).

The original Agreement established a non-default interest rate of LIBOR plus six percent, and a default rate that was four percent higher.

On the Petition Date, the outstanding principal balance under the MSR Loan Facility was approximately $152 million. Despite the many amendments to the Agreement, one provision relevant to this Motion never changed (including in Amendment Ten): the filing of a bankruptcy petition always constituted an event of default. Therefore, filing the bankruptcy petitions was an event of default. Additionally, Citibank was not repaid on the May 30, 2012 maturity date, and that was also an event of default.

After the Petition Date, Citibank entered into an agreement allowing the Debtors to use Citibank's cash collateral. The [cash collateral order] included a finding that "Citibank is oversecured and, accordingly, is entitled to interest and fees with respect to the Prepetition [Agreement]." No party challenged that finding within the 120-day challenge period. The Citibank Order required the Debtors to pay (1) interest on the prepetition MSR Loan Facility obligations at the non-default rate, (2) fees required by the Agreement at the times specified in the Agreement, and (3) Citibank's reasonable fees and costs, including fees and expenses for Citibank's professionals.

On November 21, 2012, the Court entered an order approving the sale of the Debtors' mortgage origination and servicing platform to Ocwen Loan Servicing LLC. That Sale Order required the Debtors to obtain the consent of Fannie Mae and Freddie Mac, both of which had objected to the sale. The parties settled those objections in January 2013. As required by Amendment Ten, the Sale Order authorized the Debtors to apply a portion of the sale proceeds to satisfy the Debtors' "obligations under the [Agreement]." On January 31, 2013, the date the sale closed, the Debtors paid Citibank the outstanding principal of $152 million plus interest at the contractual non-default rate.

Citibank argued that the Sale Order required the Debtors to pay Citibank accrued interest at the contract default rate. The Debtors disagreed and refused to pay interest at the contract default rate. The parties agreed the default interest issue would remain open for later resolution.

On December 11, 2013, the Court entered an order confirming the joint chapter 11 plan in these cases. Under the Plan, unsecured creditors will receive recoveries between nine percent and just over thirty-six percent of their claims. The Disclosure Statement described the dispute between Citibank and the Debtors and explained that if Citibank prevails and obtains postpetition interest at the contract default rate, "it would be entitled to an Allowed Other Secured Claim of approximately $4.5 million in addition to the amounts already paid." With the passage of time since the Motion was filed, Citibank now calculates the differential between the non-default interest which it received and the default interest it claims as $5.04 million.

Citibank also argues that the Debtors wrongly stopped paying Citibank's legal fees. In its Objection, the Trust asserts that the Debtors paid approximately $1.21 million in Citibank's legal

fees before repayment of the MSR Loan Facility, and an additional $136,000 after repayment. Unpaid fees claimed by Citibank allegedly total $351,935.20, plus $5,233.34 as of January 31, 2014. The Trust opposes any further payment of legal fees, stating at the March 26, 2014 hearing on the Motion that "under these circumstances, which . . . are really rather extreme . . . it was inequitable to pursue the default interest."

Bankruptcy Code section 506(b) provides that an oversecured creditor is entitled to interest on its secured claim, "and any reasonable fees, costs or charges provided under the agreement under which such claim arose." The oversecured creditor may receive postpetition interest up to the value of its equity cushion, i.e., the difference between the value of the allowed claim and the value of the collateral securing the claim. Section 506(b) governs a court's determination of postpetition interest; state law governs a creditor's claim for prepetition interest.

While the Bankruptcy Code governs postpetition interest, there is a rebuttable presumption that the parties' contract rate should apply. ("[A] debtor bears the burden of rebutting the presumption that the contract rate of interest applies post-petition.")

[The Court in a prior case (*Travelers*) awarded default rate interest]. The Trust argues that *Travelers* does not control here because post-*Travelers* courts have denied postpetition interest at the contract default rate on equitable grounds.

Trying to seize on this factor, the Trust argues that the rebuttable presumption is overcome here because the Debtors are insolvent, meaning that unsecured creditors will be harmed by an award of the contract rate for Citibank. The Trust notes that no Second Circuit cases involving insolvent debtors have awarded oversecured creditors contractual default interest.

Whether the debtor is insolvent is certainly an important factor courts consider in deciding whether to award an oversecured creditor postpetition interest at the contract default rate. But no court has adopted a bright line rule that the contract default rate should be refused in all insolvent debtor cases. As the court noted in Madison 92nd St. Assocs., the presumptive contract default rate should not necessarily be adjusted downward in insolvent debtor cases even though the unsecured creditors will not be paid in full: "Most chapter 11 cases involve insolvent debtors, and such an exception would swallow up the rule that the oversecured creditor is presumptively entitled to the 'contract rate.'" 472 B.R. at 200 n.7. The precise issue in Madison 92nd St. Assocs. was whether the state law statutory judgment interest rate (9%) or the federal judgment rate (0.2%) should apply in awarding postpetition interest. The court explained that "[t]he great majority of courts have concluded that the appropriate rate should be the one provided in the parties' agreement or the applicable law under which the claim arose, the so-called 'contract rate' of interest." While the parties in Madison disputed whether the debtor was insolvent (indeed, possibly, administratively insolvent), the court concluded that the contract rate or state law rate should apply. Solvency vel non is an important factor, but not the determinative factor.

Adopting a bright-line rule refusing to enforce contract default interest for oversecured creditors of insolvent debtors would likely increase the cost of credit for all high-risk borrowers if the creditor cannot protect itself from "unforeseeable costs involved with collecting from debtors in default."

Where prepetition interest is in question, the answer is clear: state law controls and contract default interest is awarded so long as state law permits it. When it comes to postpetition interest, though, the Bankruptcy Code controls payment of default interest to oversecured creditors, but the

potential economic consequences in the credit markets remain. Refusing to enforce bargained-for default interest for oversecured creditors raises the risk that lenders will demand higher interest rates from all high risk borrowers to compensate for the potentially higher costs of collection and greater risk of loss once bankruptcy begins.

That doesn't mean that the contract default rate should be awarded to all oversecured creditors in insolvent debtor cases. The Supreme Court in the seminal case of *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156 (1947), applied equitable considerations based on the purpose of bankruptcy favoring "ratable distribution of assets among the bankrupt's creditors." While the creditor in that case was oversecured, and the contract entitled the creditor to interest on interest, the Court rejected awarding that relief: "The general rule in bankruptcy and in equity receivership has been that interest on the debtors' obligations ceases to accrue at the beginning of the proceedings." If all creditors are to be repaid in full, equitable considerations permit payment of the additional interest to the secured creditor rather than to the debtor. "It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been the balance of equities between creditor and creditor or between creditors and the debtor."

The issue then is the balance of the equities. In many or even most cases involving insolvent debtors, the balance may well fall on the side of the junior secured or unsecured creditors—they are the ones that will have their distributions reduced when the oversecured creditor is awarded postpetition interest at the contract default rate.

While the issue is a close one here, the Court concludes in the exercise of discretion that the balance of equities favors the award to Citibank of contract default interest, except for the period between the Petition Date of May 14, 2012 and Amendment Ten's Maturity Date of May 30, 2012, which will be discussed below.

The Trust argues that the Court should not grant Citibank default interest at the contract rate because that award would diminish recovery to unsecured creditors. Citing the Disclosure Statement, the Trust notes that general unsecured creditor recoveries will range from nine percent to just over thirty-six percent. Awarding Citibank the contract default rate further diminishes unsecured creditor recoveries. Harm to unsecured creditors is unquestionably a factor counseling against the award of default contract interest. But, as explained below, if Amendment Ten is viewed as one piece of the Debtors' postpetition financing that enabled the Debtors to continue operating as a going concern, it is not clear that unsecured creditor recoveries were diminished from what they would have been if the Debtors had been forced to liquidate soon after the cases were filed if they had been unable to obtain sufficient postpetition financing. While it is easy to conclude that every dollar paid to Citibank today is one dollar less for unsecured creditors, what is more difficult to say is that this result today is inequitable. All creditors benefited as a result of the Debtors' ability to continue to operate as a going concern—a result that was only possible when the Debtors obtained sufficient financing to conduct their business. Citibank argues that, when put in context, granting the contract rate here would only have a "miniscule" impact on recovery by unsecured creditors because on the whole, those creditors are recovering from a $2.462 billion pool. (Motion ¶ 27; Stip. ¶ 23.) To be sure, the Court rejects Citibank's argument that $5 million is "miniscule." Nevertheless, because this is an equitable inquiry, the Court must consider the impact that awarding the contract default rate has on unsecured creditors. It would diminish the pool of distributable assets by roughly two-tenths of a percent. That reduction in distributable

assets is not—on its own—sufficient to overcome the rebuttable presumption in favor of the contractual default rate.

In this case, Amendment Ten—entered in contemplation of bankruptcy—already hiked the non-default interest rate from LIBOR plus six percent to LIBOR plus eight and one-half percent, with the default rate set four percent higher. If an oversecured lender knew that the contract default rate would not be enforced postpetition, it could have demanded a higher non-default interest rate—for example, LIBOR plus twelve and one-half percent from the date of the amendment. That would have been a steep rate, particularly when all of the fees associated with the extension were added, but not unenforceable under state law. The risk of higher rates across the board for distressed borrowers does not mean that the default rate should be enforced in all cases, but a court should pause before barring collection of default interest, even when it reduces recoveries for unsecured creditors. All of the facts and circumstances of the case should be examined. . . .

The Trust argues that additional equitable factors also weigh against default interest here. Even after the Petition Date, Citibank received timely payments of interest at the non-default rate. Even though Citibank did not receive the proceeds of the Walter Sale until seven months past the loan maturity date, the Trust argues that Citibank knowingly accepted this risk by negotiating Amendment Ten understanding that the Obligors would file for bankruptcy. The Trust also argues that repayment was never seriously at risk due to the stalking horse contracts that the Debtors secured before filing for bankruptcy.

All of this is true, but the bargain that Citibank struck for assuming these risks, whether real or exaggerated, included interest at the contract default rate. The Debtors agreed, and not in a vacuum, but in the context of negotiations with many sophisticated parties aimed at helping the Debtors proceed into bankruptcy with a semblance of order, to the benefit of secured and unsecured creditors.

Offering another reason to deny the Motion, the Trust argues that this case involves only a technical default. According to the Trust, the bankruptcy filing did not prejudice Citibank since Citibank continued to receive timely payments and was adequately protected. The Trust likens the default event clause to an ipso facto clause. Such clauses are generally disfavored, although not per se invalid in this circuit.

The Court concludes that solely as it relates to the sixteen day period in May 2012 between the Petition Date and the loan maturity date, granting the contract default rate would be inequitable. During that time, the Debtors were current on the loan, and assuming that Citibank was oversecured, it was entitled to recover its costs, fees and expenses. While the contract provision making the filing of a bankruptcy petition an event of default is not invalid as an impermissible ipso facto clause, bankruptcy policy should not penalize a debtor for filing by awarding default interest when the only default was the filing itself. Other courts have rejected default interest where the only event of default was a bankruptcy filing.

But the Debtors defaulted in a more meaningful sense later by failing to pay Citibank at the maturity date, so Citibank is entitled to recover postpetition interest at the contract default rate for the period after the maturity date.

Having found that Citibank is entitled to recover interest at the contract default rate, the Court easily concludes that Citibank should be awarded its legal fees in pursuing that relief. Even if the Court ruled against Citibank with respect to default interest, the Court would nevertheless

conclude that Citibank pursued the Motion in good faith and is entitled to recover its legal fees as provided for in the Agreement. Citibank's request for legal fees incurred in pursuing postpetition interest at the contractual default rate is GRANTED.

9.6. The Section 506(c) Surcharge

Section 506(c) allows the court to surcharge a secured creditor's collateral for the direct benefits received by the secured creditor in preserving or selling the collateral. Trustees in administratively insolvent cases look longingly at the security creditor's collateral when seeking to recover funds to pay bankruptcy administrative expenses. But secured creditor generally do not seek the aid of bankruptcy, and its accompanying administrative expenses, but rather are delayed from foreclosing by the filing of the bankruptcy case. Only when the secured creditor directly benefitted from the estate's services (such as saving the cost of foreclosure) do courts consider a surcharge, and only when the secured creditor would not have been paid in full in foreclosure (oversecured creditors generally cannot be surcharged). *In re Compton Impressions Ltd*., 217 F.3d 1256 (9th Cir. 2000) (denying surcharge where creditor would have been paid in full); *In re West Post Road Props. Corp*., 44 B.R. 244, 246 (Bankr. S.D.N.Y. 1984) (same).

Similarly, in *Hartford v. Union Planters*, 530 U.S. 1 (2000), the Supreme Court considered whether an administrative unsecured creditor could seek to surcharge a secured creditor's claim under Section 506(c). Hartford had provided workers' compensation insurance to the debtor post-petition, without receiving payment. Hartford claimed that the insurance allowed the reorganization to continue, which benefitted secured creditor Union Planters. Hartford sought to surcharge Union Planters for the cost of the insurance. The Supreme Court rejected Hartford's claim, holding that the plain language of Section 506(c) allows only the trustee (or possibly a debtor in possession who stands in the shoes of the trustee) to seek a Section 506(c) surcharge.

9.7. Section 506(d) and Striping-Down or Striping-Off Liens

One reading 506(d) in the context of the code section would surely think that the undersecured creditor's secured claim would set a limit. Take a simple example. Debtor owns a house worth $100,000, subject to a $125,000 mortgage. We've already seen that the mortgagee has a $100,000 secured claim and a $25,000 unsecured claim in bankruptcy, and is entitled to no post-petition interest, fees, costs or charges. Section 506(d) then suggests that the unsecured portion would no longer be secured by the property, could be discharged, leaving only the $100,000 secured claim as a lien against the property. This would be strip down – the lien would be stripped down to the value of the collateral, and the unsecured portion would no longer be part of the secured claim in the future.

In what was at the time a surprising decision to many, the Supreme Court in the *Dewsnup* case that follows in the materials rejected the notion that Section 506(d) allows "strip down" in Chapter 7. Ever since, courts have struggled to give Section 506(d) meaning. More recently in the *Caulkett* decision discussed below, the Supreme Court appeared to double-down on its decision in *Dewsnup*, holding that liens wholly unsecured by collateral value could also not be stripped off. A

close reading of *Caulkett* suggests that 506(d) may have new life as voting majorities on the Supreme Court shift.

These decisions only address the “strip down” and “strip off” of liens in Chapter 7 under Section 506(d). They do not address the ability to restructure debts under the reorganization chapters – a topic that will await further consideration in our orderly review of the chapter proceedings.

9.8. Cases on Stripping Liens under Section 506(d)

9.8.1. DEWSNUP v. TIMM, 502 U.S. 410 (1992)

We are confronted in this case with an issue concerning § 506(d) of the Bankruptcy Code, 11 U.S.C. § 506(d). May a debtor "strip down" a creditor's lien on real property to the value of the collateral, as judicially determined, when that value is less than the amount of the claim secured by the lien?

On June 1, 1978, respondents loaned $119,000 to petitioner Aletha Dewsnup and her husband, T. LaMar Dewsnup, since deceased. The loan was accompanied by a Deed of Trust granting a lien on two parcels of Utah farmland owned by the Dewsnups.

Petitioner defaulted the following year. Under the terms of the Deed of Trust, respondents at that point could have proceeded against the real property collateral by accelerating the maturity of the loan, issuing a notice of default, and selling the land at a public foreclosure sale to satisfy the debt.

Respondents did issue a notice of default in 1981. Before the foreclosure sale took place, however, petitioner sought reorganization under Chapter 11 of the Bankruptcy Code. That bankruptcy petition was dismissed, as was a subsequent Chapter 11 petition. In June 1984, petitioner filed a petition seeking liquidation under Chapter 7 of the Code. Because of the pendency of these bankruptcy proceedings, respondents were not able to proceed to the foreclosure sale.

In 1987, petitioner filed the present adversary proceeding in the Bankruptcy Court for the District of Utah seeking, pursuant to § 506, to "avoid" a portion of respondents' lien. Petitioner represented that the debt of approximately $120,000 then owed to respondents exceeded the fair market value of the land and that, therefore, the Bankruptcy Court should reduce the lien to that value. According to petitioner, this was compelled by the interrelationship of the security-reducing provision of § 506(a) and the lien-voiding provision of § 506(d).

The Bankruptcy Court refused to grant this relief. After a trial, it determined that the then value of the land subject to the Deed of Trust was $39,000. It indulged in the assumption that the property had been abandoned by the trustee pursuant to § 554, and reasoned that once property was abandoned it no longer fell within the reach of § 506(a), which applies only to "property in which the estate has an interest," and therefore was not covered by § 506(d). The United States District Court [and] the Court of Appeals for the Tenth Circuit, affirmed.

As we read their several submissions, the parties and their amici are not in agreement in their respective approaches to the problem of statutory interpretation that confronts us. Petitioner-

debtor takes the position that §§ 506(a) and 506(d) are complementary and to be read together. Because, under § 506(a), a claim is secured only to the extent of the judicially determined value of the real property on which the lien is fixed, a debtor can void a lien on the property pursuant to § 506(d) to the extent the claim is no longer secured and thus is not "an allowed secured claim." In other words, § 506(a) bifurcates classes of claims allowed under § 502 into secured claims and unsecured claims; any portion of an allowed claim deemed to be unsecured under § 506(a) is not an "allowed secured claim" within the lien-voiding scope of § 506(d). Petitioner argues that there is no exception for unsecured property abandoned by the trustee.

Petitioner's amicus argues that the plain language of § 506(d) dictates that the proper portion of an undersecured lien on property in a Chapter 7 case is void whether or not the property is abandoned by the trustee. It further argues that the rationale of the Court of Appeals would lead to evisceration of the debtor's right of redemption and the elimination of an undersecured creditor's ability to participate in the distribution of the estate's assets.

Respondents primarily assert that § 506(d) is not, as petitioner would have it, "rigidly tied" to § 506(a). They argue that § 506(a) performs the function of classifying claims by true secured status at the time of distribution of the estate to ensure fairness to unsecured claimants. In contrast, the lien-voiding § 506(d) is directed to the time at which foreclosure is to take place, and, where the trustee has abandoned the property, no bankruptcy distributional purpose is served by voiding the lien.

In the alternative, respondents, joined by the United States as amicus curiae, argue more broadly that the words "allowed secured claim" in § 506(d) need not be read as an indivisible term of art defined by reference to § 506(a), which by its terms is not a definitional provision. Rather, the words should be read term-by-term to refer to any claim that is, first, allowed, and, second, secured. Because there is no question that the claim at issue here has been "allowed" pursuant to § 502 of the Code and is secured by a lien with recourse to the underlying collateral, it does not come within the scope of § 506(d), which voids only liens corresponding to claims that have not been allowed and secured. This reading of § 506(d), according to respondents and the United States, gives the provision the simple and sensible function of voiding a lien whenever a claim secured by the lien itself **has not been allowed**. It ensures that the Code's determination not to allow the underlying claim against the debtor personally is given full effect by preventing its assertion against the debtor's property.

Respondents point out that pre-Code bankruptcy law preserved liens like respondents' and that there is nothing in the Code's legislative history that reflects any intent to alter that law. Moreover, according to respondents, the "fresh start" policy cannot justify an impairment of respondents' property rights, for the fresh start does not extend to an in rem claim against property but is limited to a discharge of personal liability.

The foregoing recital of the contrasting positions of the respective parties and their amici demonstrates that § 506 of the Bankruptcy Code and its relationship to other provisions of that Code do embrace some ambiguities. Hypothetical applications that come to mind and those advanced at oral argument illustrate the difficulty of interpreting the statute in a single opinion that would apply to all possible fact situations. We therefore focus upon the case before us and allow other facts to await their legal resolution on another day.

We conclude that respondents' alternative position, espoused also by the United States, although not without its difficulty, generally is the better of the several approaches. Therefore, we hold that § 506(d) does not allow petitioner to "strip down" respondents' lien, because respondents' claim is secured by a lien and has been fully allowed pursuant to § 502. Were we writing on a clean slate, we might be inclined to agree with petitioner that the words "allowed secured claim" must take the same meaning in § 506(d) as in § 506(a). But, given the ambiguity in the text, we are not convinced that Congress intended to depart from the pre-Code rule that liens pass through bankruptcy unaffected.

The practical effect of petitioner's argument is to freeze the creditor's secured interest at the judicially determined valuation. By this approach, the creditor would lose the benefit of any increase in the value of the property by the time of the foreclosure sale. The increase would accrue to the benefit of the debtor, a result some of the parties describe as a "windfall."

We think, however, that **the creditor's lien stays with the real property until the foreclosure**. That is what was bargained for by the mortgagor and the mortgagee. The voidness language sensibly applies only to the security aspect of the lien and then only to the real deficiency in the security. Any increase over the judicially determined valuation during bankruptcy rightly accrues to the benefit of the creditor, not to the benefit of the debtor and not to the benefit of other unsecured creditors whose claims have been allowed and who had nothing to do with the mortgagor-mortgagee bargain.

It is true that [the lienholder's] participation in the bankruptcy results in his having the benefit of an allowed unsecured claim as well as his allowed secured claim, but that does not strike us as proper recompense for what petitioner proposes by way of the elimination of the remainder of the lien. This result appears to have been clearly established before the passage of the 1978 Act. . . .

When Congress amends the bankruptcy laws, it does not write "on a clean slate." Furthermore, this Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history. Of course, where the language is unambiguous, silence in the legislative history cannot be controlling. But, given the ambiguity here, to attribute to Congress the intention to grant a debtor the broad new remedy against allowed claims to the extent that they become "unsecured" for purposes of § 506(a) without the new remedy's being mentioned somewhere in the Code itself or in the annals of Congress is not plausible, in our view, and is contrary to basic bankruptcy principles.

Justice Scalia, with whom Justice Souter joins, dissenting.

Read naturally and in accordance with other provisions of the statute, [506(d)] automatically voids a lien to the extent the claim it secures is not both an "allowed claim" and a "secured claim" under the Code. In holding otherwise, the Court replaces what Congress said with what it thinks Congress ought to have said—and in the process disregards, and hence impairs for future use, well established principles of statutory construction. I respectfully dissent.

The Court makes no attempt to establish a textual or structural basis for overriding the plain meaning of § 506(d), but rests its decision upon policy intuitions of a legislative character, and upon the principle that a text which is "ambiguous" (a status apparently achieved by being the subject of disagreement between self-interested litigants) cannot change pre-Code law without the

imprimatur of "legislative history." Thus abandoning the normal and sensible principle that a term (and especially an artfully defined term such as "allowed secured claim") bears the same meaning throughout the statute, the Court adopts instead what might be called the one-subsection-at-a-time approach to statutory exegesis. "[W]e express no opinion," the Court amazingly says, "as to whether the words `allowed secured claim' have different meaning in other provisions of the Bankruptcy Code." "We . . . focus upon the case before us and allow other facts to await their legal resolution on another day."

Moreover, the practical consequences of the United States' interpretation would be absurd. A secured creditor holding a lien on property that is completely worthless would not face lien avoidance under § 506(d), even if the claim secured by that lien were disallowed entirely.

The principal harm caused by today's decision is not the misinterpretation of § 506(d) of the Bankruptcy Code. The disposition that misinterpretation produces brings the Code closer to prior practice and is, as the Court irrelevantly observes, probably fairer from the standpoint of natural justice. (I say irrelevantly, because a bankruptcy law has little to do with natural justice.) The greater and more enduring damage of today's opinion consists in its destruction of predictability, in the Bankruptcy Code and elsewhere. By disregarding well-established and oft-repeated principles of statutory construction, it renders those principles less secure and the certainty they are designed to achieve less attainable. When a seemingly clear provision can be pronounced "ambiguous" sans textual and structural analysis, and when the assumption of uniform meaning is replaced by "one-subsection-at-a-time" interpretation, innumerable statutory texts become worth litigating. In the bankruptcy field alone, for example, unfortunate future litigants will have to pay the price for our expressed neutrality "as to whether the words `allowed secured claim' have different meaning in other provisions of the Bankruptcy Code." Having taken this case to resolve uncertainty regarding one provision, we end by spawning confusion regarding scores of others. I respectfully dissent.

9.9. Stripping Wholly Unsecured Liens in Chapter 7

In 2012, the Court of Appeals for the 11th Circuit created a split among the circuits by holding that a wholly unsecured junior lien could be stripped off in Chapter 7. The property was worth $141,416, and was encumbered by a first mortgage of $176,413 and a second mortgage of $44,444. The 11th Circuit allowed the debtor to strip off the second mortgage under 506(d), since there was no value in the property to support any part of the second mortgage debt. *McNeal v GMAC Mortgage*, 735 F.3d 1263 (11th Cir. 2012). Note that the **first** mortgage could not be stripped-down under *Dewsnup*.

In *Bank of America v. Caulkett*, 135 S.Ct. 1995 (2015), a unanimous Supreme Court expanded *Dewsnup* by rejecting any form of lien stripping in Chapter 7. Ironically, Justice Thomas, who took no position in *Dewsnup*, previously raised questions about *Dewsnup's* validity, stating "[t]he methodological confusion created by *Dewsnup* has enshrouded both the Courts of Appeals and . . . Bankruptcy Courts." *Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 463, and n. 3 (1999) (THOMAS, J., concurring in judgment)

By concurring in *Caulkett*, had Justice Thomas changed his mind on *Dewsnup*? It appears not. In a footnote, Justice Thomas emphasized that the Court was applying *Dewsnup* as written

because "the debtors have repeatedly insisted that they are not asking us to overrule *Dewsnup*." Three judges did not join in the footnote, indicating a split on the court between those who think *Dewsnup* was correctly decided, and those who do not. It is pretty clear that two of the judges in *Caulkett* (Scalia and Thomas) continued to believe that *Dewsnup* was wrongly decided. The three judges who refused to join in Thomas's footnote (Kennedy, Breyer and Sotomayor) support *Dewsnup*. That left four judges (Roberts, Ginsburg, Alito and Kagen) who did not commit to either side, but were willing to join in a footnote raising questions about *Dewsnup*'s validity. Allowing liens to be stripped in Chapter 7 to the value of the collateral would certainly be a major change in the law. But the decision in *Dewsnup*, as a matter of statutory construction, was far from convincing.

9.10. Redemption – 11 U.S.C. § 722

Strip-down remains a viable option for the Chapter 7 debtor only if the debtor can afford to **redeem** the property from the lien by paying the full "allowed secured claim" determined under Section 506(a). Redemption is only available to **individual debtors** seeking to redeem **tangible consumer goods**; only if the property is exempt or abandoned by the trustee; and only if the debtor can somehow afford to pay the full redemption price in cash. Redemption would often be a great deal for many consumer debtors for things like personal use cars, rent-to-own furniture, and financed computers – property that may be worth far less than the loan balance because of excessive sales prices and rapid depreciation - but few debtors have access to sufficient sources of cash to redeem.

9.11. Debtor's Treatment of Secured Claims in Chapter 7: Surrender, Redeem or Reinstate – or Maybe "Ride Through"

One of the more draconian provisions added by Congress in the 2005 BAPCPA amendments is the requirement for individual debtors holding personal property subject to a purchase money security interest to redeem, reaffirm or surrender the property. Section 521(a)(2) requires the debtor to file a statement of intention within 30 days after filing bankruptcy, and to perform the intention within 30 days after the original date for the first meeting of creditors. Next, Section 521(a)(6) specifies that the debtor may "not retain possession of" the collateral [presumably must surrender the collateral to the lender], unless within 45 days after bankruptcy the debtor has entered into an agreement with the creditor to reaffirm the loan, or the debtor has redeemed the property. 11 U.S.C. § 521(a)(6). The timing of Section 521(a)(6) conflicts with the timing of Section 521(a)(2).

Section 521(d) in turn adds teeth to the reaffirm, redeem or surrender requirement by eliminating the bankruptcy rule that ipso facto clauses are unenforceable in bankruptcy. The language does not exactly validate ipso facto clauses; rather the language provides that bankruptcy does not impair whatever right the creditor has under state law to enforce the ipso facto clause if the debtor fails to timely reaffirm or redeem. If the ipso facto clause is valid under state law, the failure to timely redeem or reaffirm will likely trigger a non-curable default because so many form loan and lease contracts contain ipso facto clauses. A corollary provision in Section 362(h)

terminates the automatic stay with respect to all security interests in, or leases of, personal property if the debtor does not timely file a statement of intention to surrender, reaffirm or redeem, and then timely perform the stated action. 11 U.S.C. § 362(h). Based on Sections 521(d) and 362(h), it would appear that the lender could promptly repossess the collateral and proceed with its non-bankruptcy remedies (foreclosure) if the collateral is not redeemed or reaffirmed – even if the loan is current - if the lender has an ipso facto clause in its loan documents. Because most debtors lack the ability to redeem, the debtor who needs the collateral (often a car) is left with the difficult choice under the Bankruptcy Code between reaffirmation and the possibility of repossession. One uncertainty remains, however. Would it be legal under state law for a lender to repossess the collateral based on an ipso facto bankruptcy default if the loan is current?

Reaffirmation, which will be covered in a later chapter, means that the debtor's personal obligation to repay the loan or lease will not be discharged. If the debtor later defaults, the debtor will not only lose the collateral but will be liable for any deficiency between the debt and the foreclosure sale price. In order to reaffirm, the debtor's lawyer must certify under penalty of perjury (or, if the debtor is *pro se*, the court must find) that reaffirmation will not impose an undue hardship on the debtor – a difficult thing for a lawyer in good conscience to do if the loan balance exceeds the value of the property, or the payments impose a substantial burden. *See* 11 U.S.C. § 524(c)(3).

An unwritten third alternative in some jurisdictions is known as "ride through." The debtor simply continues to make payments in the hope that the creditor will not elect to declare an ipso facto default and repossess the collateral. By not reaffirming, the debtor is able to walk away from the debt at a later time without liability for a deficiency.

Prior to the 2005 amendments, there was a circuit split about the availability of ride through. Compare *In re Belanger*, 962 F.2d 345, 347-348 (4th Cir. 1992) and cases cited therein allowing ride through, with *In re Burr*, 160 F.3d 843 (1st Cir. 1998) and cases cited therein not allowing ride through.

Following the 2005 amendments to Section 521 and 362, virtually all of the courts to consider the issue have rejected ride through as a legally enforceable alternative to reaffirmation or redemption. *See e.g.*, *In re Dumont*, 383 B.R. 481 (9th Cir. BAP 2007), and numerous cases cited therein.

Although ride through (simply remaining current on the loan or lease without reaffirmation) cannot prevent the lender from declaring a default under an ipso facto clause and repossessing the collateral, nothing **requires** a lender to repossess the collateral. Thus, many debtors ride through without statutory authority and simply bear the risk of repossession.

A few courts have allowed what has become known as "back door ride-through." In order to accomplish back door ride-through, the debtor must sign the reaffirmation agreement and then seek court approval for the reaffirmation. Because the debtor's attorney refuses to sign off on the reaffirmation, the debtor must appear before the judge to seek approval for the reaffirmation. The debtor's hope is to have the reaffirmation **denied** by the court on the grounds that reaffirmation is not in the debtor's best interests. Since the statutory language only requires the debtor to **agree** to reaffirm – and does not technically require that the court approve the reaffirmation – some courts achieve the ride-through remedy by denying the debtor's request to approve the reaffirmation. *See e.g.* *In re Husain*, 364 B.R. 211 (Bankr. E.D. Va.2007); *In re Blakeley*, 363 B.R. 225, 232 (Bankr.

D. Utah 2007); *In re Moustafi*, 371 B.R. 434 (Bkrtcy. Ariz. 2007); *In re Henderson*, 492 B.R. 537 (Bankr. D. Nev. 2013). These courts have held that the debtor's **effort** at reaffirmation – even if denied by the court – is all that is required to avoid ipso facto default.

As a last resort, debtors who are current on their loan or lease payments can always look to state law for protection. If the secured creditor accepts payments after bankruptcy, the debtor can argue that the secured creditor has thereby waived the ipso facto default. Alternatively, the debtor can argue that it is unconscionable under state law to allow the secured creditor to enforce the ipso facto default when the loan is current, even though the ipso facto default has not been invalidated by the bankruptcy law.

The fact is, most lenders will be better off accepting performance on a current loan or lease rather than repossessing the collateral and incurring a certain loss. But some lenders seem to think their "tough-guy" reputation is worth the individual losses because their reputation will encourage other borrowers to reaffirm. Consumer advocates disdain these rules for creating perverse incentives on lenders to repossess collateral even though everyone (lender and borrower) will be worse off by repossession.

9.12. Post-Petition Effect of Security Interests – Section 552

Outside of bankruptcy the composition of a secured creditor's collateral can change. For example, a creditor who has a security interest in the inventory of a grocery store will see the collateral increase when new inventory is purchased, and decrease when inventory is sold. The lien will "float" with the change in the identity of the debtor's inventory.

Under the general rule in Section 552(a), a secured creditor's floating lien will be cut off on the date of bankruptcy. Any additional inventory purchased by the estate will not be subject to the secured creditor's prepetition security interest.

However, Section 552(b) creates an important exception to this general rule. If the secured creditor's security interest extends to proceeds and other things that grow out of the creditor's collateral (products, offspring, rents or profits), then the prepetition security interest will extend to the proceeds and other growth of the collateral occurring post-petition. For example, if the creditor's security interest in the grocery store's inventory extends to proceeds, then the lien will attach to any money received post-petition from the sale of inventory (the money will be "cash collateral" under Section 363(a)). If that cash collateral is then used to purchase new inventory, that new inventory will also be subject to the secured creditor's security interest as well, because it too will be proceeds of the secured creditor's cash collateral. Section 552(b) requires tracing the sale of the old inventory into the purchase of new inventory.

On the other hand, if the estate buys inventory post-petition using **other money** not subject to the creditor's security interest, that new inventory will not be subject to the secured creditor's after acquired property clause. Since the new money used to buy inventory cannot be traced to the secured creditor's collateral, any post-petition benefit from honoring the secured creditor's floating lien would come at the expense of the unsecured creditors who funded the purchase of the new inventory.

The rule recognizes that if new collateral grows out of the creditor's existing collateral, then the new collateral should continue to be subject to the secured creditor's security interest. However, if money coming subject to the claims of unsecured creditors is used to create new collateral, a secured creditor should not receive the benefit of the new collateral because it would be a windfall to the secured creditor at the unsecured creditors' expense.

Under Section 552, tracing is thus very important, and the secured creditor should require a proper segregation of post-petition collateral and non-collateral in order to protect its interests.

9.13. Practice Problems: Floating Liens in Bankruptcy

Problem 1. Fresh Foods, Inc., operates a chain of grocery stores. BigBank has a perfected first priority security interest in all of Fresh Foods' inventory to secure a $1 million loan. Fresh Foods filed a Chapter 11 petition one year ago. During its post-petition operations over the past year, Fresh Foods purchased $400,000 of additional inventory. Fresh Foods' reorganization failed, and its bankruptcy case was converted to Chapter 7. The Chapter 7 trustee sold the remaining inventory for $700,000. BigBank claims to have a lien on all of the proceeds; the trustee on behalf of unsecured creditors' claims that $400,000 of the inventory was purchased post-petition and belongs to the unsecured creditors. Who is right?

Problem 2. Debtor is a farmer. Prior to bankruptcy, Debtor borrowed $100,000 from CropFinance to purchase seed, fertilizer, pesticides, and other materials for planting her crops. CropFinance has a first priority lien against the crop to secure repayment of the loan. The Debtor filed bankruptcy shortly after planting the crop. During the following six months, the trustee paid for water and labor to maintain and harvest the crop, which grew due to the passage of time. The crop was sold for $95,000. CropFinance claims entitlement to all of the proceeds from the crop on account of its security interest. The trustee says that the crop would have been worthless but for the water and labor incurred by the estate to allow the crop to grow, and therefore the proceeds of the crop should belong to the estate. Who is right?

9.14. Relief from Stay and Adequate Protection

The rights of creditors collide with the rights of the debtor and the estate under Section 362(d) of the Bankruptcy Code. Relief from stay is the main battleground for secured creditor disputes. The statute contains two primary grounds for relief from stay: (1) cause, including the lack of adequate protection (§ 362(d)(1)), and (2) lack of equity and necessity for a reorganization (§ 362(d)(2)). Read the statute carefully along with the following comments.

Neither "cause" nor "adequate protection" are defined in the Bankruptcy Code in any meaningful way. Section 361 of the Bankruptcy Code suggests some ways of providing adequate protection when required, but does not say when or to what extent adequate protection is required.

The concept of adequate protection recognizes that the debtor's and trustee's rights (to reorganize or obtain maximized value for creditors, respectively), cannot unfairly harm the rights of secured creditors to have their collateral protected from harm. If the secured creditor's collateral

is at risk of harm during the bankruptcy case, and the creditor requests protection, the estate must either provide the necessary protection or the creditor must be allowed to proceed with its state law remedies. Is the property insured against casualty loss? Is the trustee's use of the property wearing it out to the point that the decline in value threatens the secured creditor's interest? Is the property subject to a foreseeable decline in market value as time passes that will put the creditor's secured claim at risk of loss during the bankruptcy case?

The more controversial problem has been defining the creditor's interest that must be protected. Take the case of the undersecured creditor holding a $100,000 claim secured by $60,000 of collateral. If the creditor were allowed to foreclose now, the creditor could realize $60,000, and reinvest the money at interest to earn a return. The secured creditor is being prevented by the automatic stay from foreclosing and reinvesting, and thus suffers an **opportunity loss** during the pendency of the automatic stay. Must the trustee compensate the creditor for this opportunity loss even though Section 506(b) of the Bankruptcy Code denies the undersecured creditor post-petition interest on its claim? This question vexed the courts until the Supreme Court settled the issue in the *Timbers* case reprinted below.

The Bankruptcy Code allows the oversecured creditor to recover post-petition interest (and reasonable fees, costs and charges) under Section 506(b) of the Bankruptcy Code to the extent of an equity cushion, but that right to post-petition interest and any charges stops once the equity cushion is depleted. This rule puts the oversecured creditor at risk of loss as the equity cushion is depleted by the rising debt. Must the trustee adequately protect the equity cushion from decline? Once again, this question was settled in the *Bank of Alyucan* case reprinted below.

Section 362(d)(2) contains an alternative basis for relief from stay. If there is no value for the estate in keeping the property (the debtor lacks equity in the property), and the property is not necessary for the debtor's reorganization, there is no good reason to prevent the creditor from foreclosing its interest in the property. But when is property "necessary for an effective reorganization"? Is it enough for the debtor/trustee to show that the property would be needed for any reorganization to occur? Can the secured creditor be stalled for years while the court waits to see if a reorganization plan can be confirmed? The Supreme Court addressed this question too in the *Timbers* case with some very important and influential *dicta*.

While the legal questions raised by the statutory language have been largely resolved by the Supreme Court in the *Timbers* decision, there remain difficult factual questions for the bankruptcy courts to resolve in individual cases. First, determining the fair market value of the collateral, in order to determine whether the Debtor has equity in the collateral, is an art, not a science. Without a market mechanism to match buyers and sellers, the courts are left to settle a counter-factual question: how much would the property sell for if it were offered for sale? The parties hire appraisers to write lengthy reports estimating value. There are usually three approaches to value used in the reports: (1) the cost approach estimates the cost of duplicating the property. (2) The income approach estimates the present value of the income stream generated from the property using uncertain discount rates, uncertain assumptions about future income and expenses, and uncertain terminal values. (3) The report compares market sales of different properties, making discretionary adjustments for differences between the comparable and the subject property, to predict what a sale of the subject property would bring. Paid experts can justify widely varying appraisals by making different assumptions and adjustments, and bankruptcy judges, who are generally well trained in law but often not so well trained in evaluating financial projections –

must determine which experts to believe. The battle of experts is expensive for all concerned, and has often led with the benefit of hindsight to incorrect decisions by the courts.

What happens when the bankruptcy court gets the valuation wrong? If the court is wrong on the high side, the creditor is denied adequate protection and relief from stay, and may ultimately suffer a significant loss. On the low side, the debtor may prematurely lose the property to foreclosure, and with it a prospect for reorganization or profit for the unsecured creditors. The Bankruptcy Code seems to provide some relief when the court's adequate protection determination turns out to be inadequate, in the form of a super-administrative claim under Section 507(b) of the Bankruptcy Code, but as seen in the *Dobbins* case reprinted below, some courts have interpreted Section 507(b) in a surprisingly limited way.

9.15. Cases on Relief from Stay

9.15.1. UNITED SAVINGS v. TIMBERS OF INWOOD FOREST, 484 U.S. 365 (1988)

JUSTICE SCALIA delivered the opinion of the Court.

[Debtor Timbers borrowed $4.1 million from United Savings in 1982. The loan was secured by a lien against an apartment project owned by the Debtor. The loan contained an assignment of rents. After the Debtor filed bankruptcy, United Savings moved for relief from stay.] At a hearing before the Bankruptcy Court, it was established that respondent [the Debtor] owed petitioner [United Savings] $4,366,388.77, and evidence was presented that the value of the collateral was somewhere between $2,650,000 and $4,250,000. The collateral was appreciating in value, but only very slightly. It was therefore undisputed that petitioner was an undersecured creditor.

Respondent had agreed to pay petitioner the postpetition rents from the apartment project (covered by the after-acquired property clause in the security agreement), minus operating expenses. Petitioner contended, however, that it was entitled to additional compensation. The Bankruptcy Court agreed and conditioned continuance of the stay on monthly payments by respondent, at the market rate of 12% per annum, on the estimated amount realizable on foreclosure, $4,250,000—commencing six months after the filing of the bankruptcy petition, to reflect the normal foreclosure delays. The District Court affirmed but the Fifth Circuit en banc reversed.

We granted certiorari to determine whether undersecured creditors are entitled to compensation under 11 U.S.C. 362(d)(1) for the delay caused by the automatic stay in foreclosing on their collateral.

It is common ground that the "interest in property" referred to by § 362(d)(1) includes the right of a secured creditor to have the security applied in payment of the debt upon completion of the reorganization; and that that interest is not adequately protected if the security is depreciating during the term of the stay. Thus, it is agreed that if the apartment project in this case had been declining in value petitioner would have been entitled, under § 362(d)(1), to cash payments or additional security in the amount of the decline, as § 361 describes. The crux of the present dispute

is that petitioner asserts, and respondent denies, that the phrase "interest in property" also includes the secured party's right (suspended by the stay) to take immediate possession of the defaulted security, and apply it in payment of the debt. If that right is embraced by the term, it is obviously not adequately protected unless the secured party is reimbursed for the use of the proceeds he is deprived of during the term of the stay.

The term "interest in property" certainly summons up such concepts as "fee ownership," "life estate," "co-ownership," and "security interest" more readily than it does the notion of "right to immediate foreclosure." Nonetheless, viewed in the isolated context of § 362(d)(1), the phrase could reasonably be given the meaning petitioner asserts. Statutory construction, however, is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law. That is the case here. Section 362(d)(1) is only one of a series of provisions in the Bankruptcy Code dealing with the rights of secured creditors. The language in those other provisions, and the substantive dispositions that they effect, persuade us that the "interest in property" protected by § 362(d)(1) does not include a secured party's right to immediate foreclosure.

Section 506 of the Code defines the amount of the secured creditor's allowed secured claim and the conditions of his receiving postpetition interest. . . . In subsection (a) of this provision the creditor's "interest in property" obviously means his security interest without taking account of his right to immediate possession of the collateral on default. If the latter were included, the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended. The phrase "value of such creditor's interest" in § 506(a) means "the value of the collateral." H.R.Rep. No. 95-595, pp. 181, 356 (1977); We think the phrase "value of such entity's interest" in § 361(1) and (2), when applied to secured creditors, means the same.

Even more important for our purposes than § 506's use of terminology is its substantive effect of denying undersecured creditors postpetition interest on their claims—just as it denies over secured creditors postpetition interest to the extent that such interest, when added to the principal amount of the claim, will exceed the value of the collateral. Section 506(b) . . . permits postpetition interest to be paid only out of the "security cushion," the undersecured creditor, who has no such cushion, falls within the general rule disallowing postpetition interest. If the Code had meant to give the undersecured creditor, who is thus denied interest on his claim, interest on the value of his collateral, surely this is where that disposition would have been set forth, and not obscured within the "adequate protection" provision of § 362(d)(1). Instead of the intricate phraseology set forth above, § 506(b) would simply have said that the secured creditor is entitled to interest "on his allowed claim, or on the value of the property securing his allowed claim, whichever is lesser." Petitioner's interpretation of § 362(d)(1) must be regarded as contradicting the carefully drawn disposition of § 506(b).

Petitioner seeks to avoid this conclusion by characterizing § 506(b) as merely an alternative method for compensating oversecured creditors, which does not imply that no compensation is available to undersecured creditors. This theory of duplicate protection for oversecured creditors is implausible even in the abstract, but even more so in light of the historical principles of

bankruptcy law. Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors. "To allow a secured creditor interest where his security was worth less than the value of his debt was thought to be inequitable to unsecured creditors." *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 164 (1946). It was considered unfair to allow an undersecured creditor to recover interest from the estate's unencumbered assets before unsecured creditors had recovered any principal. We think it unlikely that § 506(b) codified the pre-Code rule with the intent, not of achieving the principal purpose and function of that rule, but of providing over-secured creditors an alternative method of compensation. Moreover, it is incomprehensible why Congress would want to favor undersecured creditors with interest if they move for it under § 362(d)(1) at the inception of the reorganization process—thereby probably pushing the estate into liquidation—but not if they forbear and seek it only at the completion of the reorganization.

Second, petitioner's interpretation of § 362(d)(1) is structurally inconsistent with 11 U.S.C. 552. Section 552(a) states the general rule that a prepetition security interest does not reach property acquired by the estate or debtor postpetition. Section 552(b) sets forth an exception, allowing postpetition "proceeds, product, offspring, rents, or profits" of the collateral to be covered only if the security agreement expressly provides for an interest in such property, and the interest has been perfected under "applicable nonbankruptcy law." Section 552(b) therefore makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors. Under petitioner's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under § 362. It is true that § 506(b) gives the over secured creditor, despite lack of compliance with the conditions of § 552, a similar priority over unsecured creditors; but that does not compromise the principle of § 552, since the interest payments come only out of the "cushion" in which the oversecured creditor does have a perfected security interest.

Third, petitioner's interpretation of § 362(d)(1) makes nonsense of § 362(d)(2). On petitioner's theory, the undersecured creditor's inability to take immediate possession of his collateral is always "cause" for conditioning the stay (upon the payment of market rate interest) under § 362(d)(1), since there is, within the meaning of that paragraph, "lack of adequate protection of an interest in property." But § 362(d)(2) expressly provides a different standard for relief from a stay "of an act against property," which of course includes taking possession of collateral. By applying the "adequate protection of an interest in property" provision of § 362(d)(1) to the alleged "interest" in the earning power of collateral, petitioner creates the strange consequence that § 362 entitles the secured creditor to relief from the stay (1) if he is undersecured (and thus not eligible for interest under § 506(b)), or (2) if he is undersecured and his collateral "is not necessary to an effective reorganization." This renders § 362(d)(2) a practical nullity and a theoretical absurdity. If § 362(d)(1) is interpreted in this fashion, an undersecured creditor would seek relief under § 362(d)(2) only if his collateral was not depreciating (or he was being compensated for depreciation) and it was receiving market rate interest on his collateral, but nonetheless wanted to foreclose. Petitioner offers no reason why Congress would want to provide relief for such an obstreperous and thoroughly unharmed creditor.

Section 362(d)(2) also belies petitioner's contention that undersecured creditors will face inordinate and extortionate delay if they are denied compensation for interest lost during the stay as part of "adequate protection" under § 362(d)(1). Once the movant under § 362(d)(2) establishes that he is an undersecured creditor, it is the burden of the debtor to establish that the collateral at issue is "necessary to an effective reorganization." See § 362(g). **What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization that is in prospect.** This means, as many lower courts, including the en banc court in this case, have properly said, that **there must be "a reasonable possibility of a successful reorganization within a reasonable time**." The cases are numerous in which § 362(d)(2) relief has been provided within less than a year from the filing of the bankruptcy petition. And while the bankruptcy courts demand less detailed showings during the four months in which the debtor is given the exclusive right to put together a plan, see 11 U.S.C. 1121(b), (c)(2), even within that period lack of any realistic prospect of effective reorganization will require § 362(d)(2) relief.

The Fifth Circuit correctly held that the undersecured petitioner is not entitled to interest on its collateral during the stay to assure adequate protection under 11 U.S.C. 362(d)(1). Petitioner has never sought relief from the stay under § 362(d)(2) or on any ground other than lack of adequate protection. Accordingly, the judgment of the Fifth Circuit is affirmed.

9.15.2. BANKERS LIFE INS. CO., v. ALYUCAN INTERSTATE CORP., 12 B.R. 803 (Bankr. D. Utah 1981)

This case raises the question whether an "equity cushion" is necessary to provide adequate protection under 11 U.S.C. Section 362(d)(1).[1] This Court concludes that it is not.

On January 14, 1981, debtor, a construction and real estate development firm, filed a petition under Chapter 11 of the Code. On May 4, Bankers Life, holder of a trust deed on realty owned by debtor, brought this action for relief from the automatic stay under Section 362(d). The complaint alleges that the realty secures a debt in the principal amount of $1,220,000 and that Bankers Life is not adequately protected. On May 20, the preliminary hearing contemplated by Section 362(e) was held. After receiving evidence, the Court fixed the value of the realty on the date of the petition at $1,425,000 and found that there had been no erosion in that value as of the hearing. The debt owing was $1,297,226 as of the petition, and with interest accruing at roughly $8,000 per month, had increased to $1,330,761 as of the hearing. Thus, there was an "equity cushion" of $127,774 or approximately nine percent of the value of the collateral, as of the petition, which had decreased to $94,239, or approximately six and one half percent of the value of the collateral, as of the hearing. As interest accumulates, and if no payments are made, this cushion will dissipate within a year.

[T]here is a trend toward defining adequate protection in terms of an "equity cushion": the difference between outstanding debt and the value of the property against which the creditor desires to act. Where the difference is substantial, a cushion is said to exist, adequately protecting the creditor. As interest accrues, or depreciation advances, and the margin declines, the cushion weakens and the stay may be lifted. Naturally, courts disagree on what is an acceptable margin. The emerging view, however, may be that the stay should be terminated when the cushion will be

absorbed through interest, commissions, and other costs of resale. The cushion analysis enjoys practical appeal and ease of application.

This Court rejects a cushion analysis. . . . Under Section 362(d)(2) a lack of equity, absent a further showing that the property is unnecessary to an effective reorganization, does not warrant relief from the stay. This statutory provision expresses a legislative judgment, first, that it is the absence of equity rather than any particular cushion which is the criterion for relief from stay, and second, that the absence of equity is not alone dispositive — the court must still weigh the necessity of the property to an effective reorganization. The cushion analysis is inconsistent with this judgment. It makes surplusage out of Section 362(d)(2) which speaks in terms of equity and reorganization. Indeed, this dual requirement emphasizes the role of equity, when present, not as a cushion, but to underwrite, through sale or credit, the rehabilitation of debtors. . . .

Although the "idea of equity" became "something of a totem for courts," it was equity in the sense contemplated under Section 362(d)(2), not an equity cushion. Thus, it was acknowledged that "deciding whether to continue or vacate the stay solely on the ground of the debtor's equity in the property may produce an unjust result," for example where "the encumbered property is so vital to the operation of debtor's business that foreclosure will simply not be allowed."

Similarly, another commentator describes the "operative equities" which are weighed in relief from stay actions, to include the debtor's need for the property, harm to the creditor, stage of the proceedings, and "how persuasive the indications are that the debtor can fabricate a plan susceptible of confirmation," but warns against "red herrings." "One of these is the oft mentioned concern as to how much equity the debtor has in property sought by a secured creditor. If the equity is large, that is the reason for granting relief [to the debtor] which might be denied if it were not. Yet, that judgment ought to be largely immaterial, since the equity can presumably be salvaged for the debtor in liquidation of the property as part of the administration of the estate or upon its surrender to the secured creditor, particularly where the court exercises its discretion to control the time and manner of liquidation. It is submitted that the real determinants should be and probably are the factors just suggested. For example, if a debtor badly needs the property and its vital signs are strong, the size of its equity shouldn't have much bearing on the situation, although a large equity does make a decision favorable to the debtor more palatable for all concerned."

Adequate protection is a concept designed to balance the rights of creditors and debtors in the preliminary stages of reorganization. It is, in each case, ad hoc. For this reason the cushion analysis, which may be helpful in general, falls short in the particular. It is not fully alert to the legislative directive that "the facts," in each hearing under Section 362(d), "will determine whether relief is appropriate under the circumstances." H.R.Rep.No.95-595, 95th Cong., 1st Sess. 344 (1977). The facts of each case, thoughtfully weighed, not formularized, define adequate protection.

9.15.3. FORD MOTOR CREDIT COMPANY v. DOBBINS, 35 F.3d 860 (4th Cir. 1994)

From 1970 until 1980 Dobbins operated a car dealership in Roanoke, Virginia. In 1980, as a result of financial problems, the Dealership ceased operating. On March 3, 1981, the Dealership

filed a petition under Chapter 11 of the Bankruptcy Code. That same day the Dobbinses filed their own Chapter 11 petition.

FMCC provided financing to the dealership. The loans were secured by certain personal property of the dealership, including parts and equipment. The Dobbinses personally guaranteed payment of the Dealership's debt to FMCC. The Dobbinses' guaranty was secured by a deed of trust on their Melrose Avenue property, which was where the Dealership was located.

On April 7, 1982, FMCC moved for relief from the automatic stay in the Dobbinses' bankruptcy case to foreclose on the Melrose Avenue property. FMCC asserted that the value of its claim was $697,720.54. FMCC and the Dobbinses presented expert testimony on the value of the secured collateral. FMCC's experts valued the Melrose Avenue property at $425,000 and the remaining personal property of the Dealership at $47,731. The Dobbinses' and the Dealership's experts valued the Melrose Avenue property at $898,000 and the remaining personal property at $190,000.

On March 31, 1983, the bankruptcy court entered an order finding that "[FMCC's] interest [was] adequately protected by the equity in the subject property." Accordingly, the court denied FMCC's motion for relief from the stay pending a hearing on the reorganization plans of both the Dealership and the Dobbinses.

On November 29, 1983, the bankruptcy court issued orders confirming the plans in both cases. The Dealership's plan provided for the sale of property. The plan said that if the Melrose Avenue Property was not sold by November 30, 1984, the Dobbinses would be in default and FMCC could take possession [and foreclose].

The Dobbinses were unable to sell the Melrose Avenue property. On February 10, 1986, the bankruptcy court lifted the stay so that FMCC could sell the property. FMCC listed the property with a realty agency that specialized in marketing commercial property. On January 30, 1987, about one year after the court lifted the stay, FMCC finally sold the Melrose Avenue property for $375,000 at a private sale. The court approved the sale over the Dobbinses' objection that the price was too low. After sale-related costs and expenses were deducted, the net sale proceeds ($301,123.83) were applied to FMCC's claim.

Following the sale, FMCC filed a Second Amended Proof of Claim in the Dobbinses' bankruptcy case for its deficiency in the amount of $545,639.41, which included postpetition interest, legal fees and expenses. Significantly, in its Second Amended Proof of Claim FMCC sought a superpriority administrative expense under 11 U.S.C. § 507(b) for the alleged decrease in the value of the Melrose Avenue property from the date of the adequate protection order to the date of the sale. The Dobbinses objected.

The bankruptcy court ruled that FMCC was not entitled to a § 507(b) superpriority [or postpetition interest]. The district court reversed. The district court held that FMCC was entitled to a § 507(b) superpriority in the amount of $322,720.54 because the "adequate protection" proved to be inadequate [and to post-petition interest]. . . .

[Superpriority under 507(b).]

FMCC contends that it is entitled to a superpriority administrative expense under § 507(b) because the value of the Melrose Avenue property declined after the adequate protection order,

with the property eventually selling for less than the amount of FMCC's claim. In short, adequate protection proved to be inadequate.

It is apparent from the language of § 507(b) that a creditor must satisfy several requirements in order to trigger the superpriority. First, adequate protection must have been provided previously, and the protection ultimately must prove to be inadequate. Second, the creditor must have a claim allowable under § 507(a)(1) (which in turn requires that the creditor have an administrative expense claim under § 503(b)). And third, the claim must have arisen from either the automatic stay under § 362; or the use, sale or lease of the collateral under § 363; or the granting of a lien under § 364(d). For the reasons that follow, we conclude that FMCC is not entitled to a § 507(b) superpriority because it does not meet the second requirement above, i.e., it does not have a claim allowable under § 507(a)(1).

"The presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among the creditors. Thus, statutory priorities must be narrowly construed." Heeding this principle, we begin with the language of § 507(b), which allows a superpriority only to a claim otherwise allowable under § 507(a)(1). Section 507(a)(1), in turn, allows a claim for "administrative expenses allowable under § 503(b)...." For our purposes, the administrative expenses allowable under § 503(b) are "the actual, necessary costs and expenses of preserving the estate...." Thus, FMCC cannot receive a § 507(b) superpriority unless it can demonstrate that it has incurred postpetition an actual and necessary cost or expense of preserving the Dobbinses' estate.

"The modifiers `actual' and `necessary' must be observed with scrupulous care[,]"because [o]ne of the goals of Chapter 11 is to keep administrative costs to a minimum in order to preserve the debtor's scarce resources and thus encourage rehabilitation. In keeping with this goal, § 503(b)(1)(A) was not intended to "saddle debtors with special post-petition obligations lightly or give preferential treatment to certain select creditors by creating a broad category of administrative expenses." This ... narrow interpretation requires actual use of the creditor's property by the debtor, thereby conferring a concrete benefit on the estate before a claim is allowable as an administrative expense. Accordingly, the mere potential of benefit to the estate is insufficient for the claim to acquire status as an administrative expense. The court's administrative expense inquiry centers upon whether the estate has received an actual benefit, as opposed to the loss a creditor might experience by virtue of the debtor's possession of its property.

With this background in mind, we examine FMCC's argument, which essentially boils down to this: The Dobbinses used, and the Dobbinses' estate received a benefit from, the Melrose Avenue property in that the Dobbinses had the opportunity to market the property. We are presented with a close question here, but we do not believe that the mere opportunity to market collateral is the type of concrete, actual benefit contemplated by § 503(b)(1)(A).

In sum, there is a critical distinction between an actual benefit to the estate resulting from the actual postpetition use of collateral and a potential benefit to the estate resulting from a debtor's mere possession of collateral.

FMCC's theory is that a debtor's opportunity to benefit from the continued possession postpetition of collateral constitutes an actual and necessary cost of preserving the estate for purposes of § 503(b)(1)(A). But every time a bankruptcy court denies a secured creditor's motion to lift the stay the debtor is given some "opportunity" to benefit from the continued possession of the collateral (e.g., to use, lease or sell it). Thus, were we to adopt FMCC's theory, we would be

hard pressed to find a case where a creditor would not be entitled to a superpriority after adequate protection proved inadequate. In effect, FMCC would have us read out of § 507(b) Congress' requirement (in its cross-reference to § 503(b)) that the creditor must have incurred an actual and necessary cost of preserving the estate. Because a literal application of § 507(b) would not produce a result demonstrably at odds with Congressional intent, we must reject FMCC's broad conception of "use" and "benefit."

We appreciate that FMCC wants to be compensated for the delay and related opportunity loss occasioned by the Dobbinses' continued possession of its collateral. And we agree that in many cases "it would be inequitable to tax the creditor with the burden of the court's error if the judicially determined adequate protection later proves to be `inadequate.'" However, it also strikes us as inequitable to tax unsecured creditors for a decline in the value of collateral when the decline does not result from a use that actually benefits the estate: "To prioritize ... claims where they are not clearly entitled to such treatment, is not only inconsistent with the policy of equality of distribution but it also dilutes the value of the priority for the claims of creditors Congress in fact intended to prefer."

Postpetition Interest Under § 506(b)

FMCC says it is entitled to postpetition interest on its various loans to the Dealership. The general rule is that interest stops accruing when the bankruptcy petition is filed. See 11 U.S.C. § 502(b)(2). However, in § 506(b) Congress carved out an exception for oversecured creditors. "Section 506(b)'s denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors."

The first and critical inquiry under § 506(b) is whether FMCC is oversecured. The Dobbinses argue, and the bankruptcy court found, that FMCC is undersecured for purposes of § 506(b) because the Melrose Avenue property ultimately sold for an amount less than FMCC's secured claim. FMCC concedes that, if we use the sale price to determine the value of the collateral for purposes of § 506(b), then it is undersecured. But, FMCC urges, although it was undersecured at the time of sale, it was oversecured earlier in the bankruptcy proceedings — the value of the Melrose Avenue property simply declined between the filing of the petition and the time the property was sold. FMCC contends that so long as a creditor is oversecured at some point postpetition, the creditor should be treated as an oversecured creditor for purposes of § 506(b), even if the creditor ultimately ends up undersecured when the collateral is sold. The district court agreed with FMCC and reversed the bankruptcy court.

We hold that when secured collateral has been sold, so long as the sale price is fair and is the result of an arm's-length transaction, courts should use the sale price, not some earlier hypothetical valuation, to determine whether a creditor is oversecured and thus entitled to postpetition interest under § 506(b

Using the sale price thus makes practical sense because it is "conclusive evidence of the property's value," *Alpine Group*, 151 B.R. at 935, and it is the amount of money the collateral actually was able to bring into the estate for distribution.

If, as FMCC urges, we value the collateral on the basis of a hypothetical valuation made earlier in the proceedings, and if that earlier valuation is higher than the sale price, then every dollar of postpetition interest awarded above the sale price is a dollar usurped from the estate's

unencumbered assets, a dollar that would otherwise be available for distribution to unsecured creditors. By using sale price, we avoid this inequitable result. Of course, secured creditors may benefit by a § 506(b) valuation based on sale price if the collateral appreciates postpetition and the property is sold for more than it was appraised earlier in the proceedings.

In sum, when valuing secured collateral to determine whether a creditor is oversecured and thus entitled to postpetition interest pursuant to § 506(b), if the collateral has been sold, the value of the collateral should be based on the consideration received by the estate in connection with the sale, provided that the sale price is both fair and the result of an arm's-length transaction. Here, because the net consideration received in connection with the sale of the Melrose Avenue property is less than the amount of FMCC's claim, FMCC is an undersecured creditor for purposes of § 506(b) and thus is not entitled to any postpetition interest.

9.16. Practice Problems: Relief from Stay

Problem 1. You represent a plaintiff bringing a class action lawsuit against 100 defendants. You are set for trial in three weeks. One of the defendants files bankruptcy. You do not want to delay the trial. What should you do?

Problem 2. Bank made a $100,000 loan secured by the debtor's real property. According to the loan documents, interest accrues at the rate of 1% per month, but interest is not compounded (no interest on unpaid interest). The Bank filed a motion for relief from stay asserting that it was owed $100,000 of principal, $5,000 of interest, and $2,000 in legal fees as of the date the bankruptcy petition was filed, and will be owed an additional $4,000 in post-petition interest and $3,000 in post-petition legal fees as of the date of the hearing. If the court determines that the property is worth $120,000, what claims will the Bank have, what will the Bank have to show to get relief from stay, and what will the debtor have to show to avoid relief from stay?

Problem 3. What difference would it make, if any, in the last problem if the property was worth $123,000, but was also encumbered by a second lien in the amount of $10,000?

Problem 4. What if the second lienholder in Problem (3) sought relief from stay?

Problem 5. Suppose the property in Problem (2) is worth $115,000, and is encumbered by a second mortgage of $25,000. Can the second mortgage be stripped down to the secured claim of $1,000?

Problem 6. What would the claims be in Problem (5) if the property was worth only $110,000 on the hearing date? Could the second mortgage be stripped off as an unsecured claim?

Problem 7. The debtor purchased a car two years ago, borrowing $25,000 at 28% interest on a five year loan. The debtor's monthly payments are $778.40, and the current loan balance is $18,818.38. The "blue book" lists the car as having a $10,000 trade-in value, an $11,000 private sale value, and a $12,000 retail value. The debtor needs the car to get to work. The debtor has asked you to sign off on a reaffirmation of the loan. What do you say?

Problem 8. The Debtor owns a Dull brand laptop computer that the debtor needs for his job. He owes Dull $1,200, and the laptop is worth $400. He bought the laptop from Dull Computer

Corporation 7 months ago, and Dull's interest rate on the loan is 35%. The contract payments are $55 per month, and there are three years left on the term. What options does the debtor have?

Chapter 10. Unsecured Claims in Bankruptcy

10.1. What is a "Claim"?

The drafters of the Bankruptcy Code adopted an extremely broad definition of a "claim" to resolve all of the debtor's liabilities as part of the bankruptcy process. Section 101(5) of the Bankruptcy Code defines a claim as either a "right to payment," or the "right to an equitable remedy" if the breach "gives rise to a right to payment." Under the definition, one has a claim in bankruptcy whether or not the claim is reduced to judgment, is liquidated or unliquidated, is fixed or contingent, is matured or unmatured, is legal or equitable, or is secured or unsecured. Under the statute, if a right to payment from the debtor exists in any fashion, it is a claim that will be subject to the process of bankruptcy.

Despite the broad statutory definition, there is one fundamental limitation on the definition of a claim – the constitutional requirement of due process mandated by the 5th Amendment. The cases that follow attempt to draw the line between the policy of bankruptcy to resolve all of the debtor's liabilities at once, and the policies of due process and fundamental fairness that are so fundamental to our system of justice.

10.2. Cases on Claims and Due Process

10.2.1. MULLANE v. CENTRAL HANOVER BANK & TRUST CO., 339 U.S. 306 (1950)

MR. JUSTICE JACKSON delivered the opinion of the Court.

This controversy questions the constitutional sufficiency of notice to beneficiaries on judicial settlement of accounts by the trustee of a common trust fund established under the New York Banking Law. The New York Court of Appeals considered and overruled objections that the statutory notice contravenes requirements of the Fourteenth Amendment, and that, by allowance of the account, beneficiaries were deprived of property without due process of law. Common trust fund legislation is addressed to a problem appropriate for state action. Mounting overheads have made administration of small trusts undesirable to corporate trustees. In order that donors and testators of moderately sized trusts may not be denied the service of corporate fiduciaries, the District of Columbia and some thirty states other than New York have permitted pooling small trust estates into one fund for investment administration. The income, capital gains, losses and expenses of the collective trust are shared by the constituent trusts in proportion to their contribution. By this plan, diversification of risk and economy of management can be extended to those whose capital standing alone would not obtain such advantage.

Under [New York Banking Law, the assets of small trusts may be pooled. The Court can issue a decree settling the accounts by publishing notice]. The decree, in each such judicial settlement of accounts, is made binding and conclusive as to any matter set forth in the account upon everyone having any interest in the common fund or in any participating estate, trust or fund.

In January, 1946, Central Hanover Bank and Trust Company established a common trust fund in accordance with these provisions, and, in March, 1947, it petitioned the Surrogate's Court for settlement of its first account as common trustee. During the accounting period, a total of 113 trusts, approximately half *inter vivos* and half testamentary, participated in the common trust fund, the gross capital of which was nearly three million dollars. The record does not show the number or residence of the beneficiaries, but they were many, and it is clear that some of them were not residents of the State of New York.

The only notice given beneficiaries of this specific application was by publication in a local newspaper in strict compliance with [New York Banking Law]. Thus, the only notice required, and the only one given, was by newspaper publication setting forth merely the name and address of the trust company, the name and the date of establishment of the common trust fund, and a list of all participating estates, trusts or funds.

At the time the first investment in the common fund was made on behalf of each participating estate; however, the trust company had notified by mail each person of full age and sound mind whose name and address was then known to it and who was [a beneficiary of the trust]. Included in the notice was a copy of those provisions of the Act relating to the sending of the notice itself and to the judicial settlement of common trust fund accounts.

Upon the filing of the petition for the settlement of accounts, appellant was, by order of the court appointed special guardian and attorney for all persons known or unknown not otherwise appearing who had or might thereafter have any interest in the income of the common trust fund, and appellee Vaughan was appointed to represent those similarly interested in the principal. There were no other appearances on behalf of anyone interested in either interest or principal.

Appellant appeared specially, objecting that notice and the statutory provisions for notice to beneficiaries were inadequate to afford due process under the Fourteenth Amendment, and therefore that the court was without jurisdiction to render a final and binding decree. Appellant's objections were entertained and overruled, the Surrogate holding that the notice required and given was sufficient. A final decree accepting the accounts has been entered [and affirmed by the lower courts]. The effect of this decree, as held below, is to settle "all questions respecting the management of the common fund." We understand that every right which beneficiaries would otherwise have against the trust company, either as trustee of the common fund or as trustee of any individual trust, for improper management of the common trust fund during the period covered by the accounting is sealed and wholly terminated by the decree. [The Court then recognizes New York’s power to discharge trustees even if the beneficiaries live out of state]

Quite different from the question of a state's power to discharge trustees is that of the opportunity it must give beneficiaries to contest. Many controversies have raged about the cryptic and abstract words of the Due Process Clause, but there can be no doubt that, at a minimum, they require that deprivation of life, liberty or property by adjudication be preceded by notice and opportunity for hearing appropriate to the nature of the case.

In two ways, this proceeding does or may deprive beneficiaries of property. It may cut off their rights to have the trustee answer for negligent or illegal impairments of their interests. Also, their interests are presumably subject to diminution in the proceeding by allowance of fees and expenses to one who, in their names but without their knowledge, may conduct a fruitless or

uncompensatory contest. Certainly the proceeding is one in which they may be deprived of property rights and hence notice and hearing must measure up to the standards of due process.

Personal service of written notice within the jurisdiction is the classic form of notice always adequate in any type of proceeding. But the vital interest of the State in bringing any issues as to its fiduciaries to a final settlement can be served only if interests or claims of individuals who are outside of the State can somehow be determined. A construction of the Due Process Clause which would place impossible or impractical obstacles in the way could not be justified.

Against this interest of the State, we must balance the individual interest sought to be protected by the Fourteenth Amendment. This is defined by our holding that "[t]he fundamental requisite of due process of law is the opportunity to be heard." This right to be heard has little reality or worth unless one is informed that the matter is pending and can choose for himself whether to appear or default, acquiesce or contest.

The Court has not committed itself to any formula achieving a balance between these interests in a particular proceeding or determining when constructive notice may be utilized, or what test it must meet. Personal service has not, in all circumstances, been regarded as indispensable to the process due to residents, and it has more often been held unnecessary as to nonresidents. We disturb none of the established rules on these subjects. No decision constitutes a controlling, or even a very illuminating, precedent for the case before us. But a few general principles stand out in the books.

An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections. The notice must be of such nature as reasonably to convey the required information, and it must afford a reasonable time for those interested to make their appearance. But if, with due regard for the practicalities and peculiarities of the case, these conditions are reasonably met, the constitutional requirements are satisfied.

But when notice is a person's due, process which is a mere gesture is not due process. The means employed must be such as one desirous of actually informing the absentee might reasonably adopt to accomplish it. The reasonableness, and hence the constitutional validity of, any chosen method may be defended on the ground that it is, in itself, reasonably certain to inform those affected, or, where conditions do not reasonably permit such notice, that the form chosen is not substantially less likely to bring home notice than other of the feasible and customary substitutes.

It would be idle to pretend that publication alone, as prescribed here, is a reliable means of acquainting interested parties of the fact that their rights are before the courts. It is not an accident that the greater number of cases reaching this Court on the question of adequacy of notice have been concerned with actions founded on process constructively served through local newspapers. Chance alone brings to the attention of even a local resident an advertisement in small type inserted in the back pages of a newspaper, and, if he makes his home outside the area of the newspaper's normal circulation, the odds that the information will never reach him are large indeed. The chance of actual notice is further reduced when, as here, the notice required does not even name those whose attention it is supposed to attract, and does not inform acquaintances who might call it to attention. In weighing its sufficiency on the basis of equivalence with actual notice, we are unable to regard this as more than a feint.

Nor is publication here reinforced by steps likely to attract the parties' attention to the proceeding. It is true that publication traditionally has been acceptable as notification supplemental to other action which, in itself, may reasonably be expected to convey a warning. The ways of an owner with tangible property are such that he usually arranges means to learn of any direct attack upon his possessory or proprietary rights. Hence, libel of a ship, attachment of a chattel or entry upon real estate in the name of law may reasonably be expected to come promptly to the owner's attention. When the state within which the owner has located such property seizes it for some reason, publication or posting affords an additional measure of notification. A state may indulge the assumption that one who has left tangible property in the state either has abandoned it, in which case proceedings against it deprive him of nothing, or that he has left some caretaker under a duty to let him know that it is being jeopardized.

In the case before us, there is, of course, no abandonment. On the other hand, these beneficiaries do have a resident fiduciary as caretaker of their interest in this property. But it is their caretaker who, in the accounting, becomes their adversary. Their trustee is released from giving notice of jeopardy, and no one else is expected to do so. Not even the special guardian is required or apparently expected to communicate with his ward and client, and, of course, if such a duty were merely transferred from the trustee to the guardian, economy would not be served and more likely the cost would be increased.

This Court has not hesitated to approve of resort to publication as a customary substitute in another class of cases where it is not reasonably possible or practicable to give more adequate warning. Thus, it has been recognized that, in the case of persons missing or unknown, employment of an indirect, and even a probably futile, means of notification is all that the situation permits, and creates no constitutional bar to a final decree foreclosing their rights.

Those beneficiaries represented by appellant whose interests or whereabouts could not, with due diligence, be ascertained come clearly within this category. As to them, the statutory notice is sufficient. However great the odds that publication will never reach the eyes of such unknown parties, it is not in the typical case, much more likely to fail than any of the choices open to legislators endeavoring to prescribe the best notice practicable.

Nor do we consider it unreasonable for the State to dispense with more certain notice to those beneficiaries whose interests are either conjectural or future or, although they could be discovered upon investigation, do not, in due course of business, come to knowledge of the common trustee. Whatever searches might be required in another situation under ordinary standards of diligence, in view of the character of the proceedings and the nature of the interests here involved, we think them unnecessary. We recognize the practical difficulties and costs that would be attendant on frequent investigations into the status of great numbers of beneficiaries, many of whose interests in the common fund are so remote as to be ephemeral, and we have no doubt that such impracticable and extended searches are not required in the name of due process. The expense of keeping informed from day to day of substitutions among even current income beneficiaries and presumptive remaindermen, to say nothing of the far greater number of contingent beneficiaries, would impose a severe burden on the plan, and would likely dissipate its advantages. These are practical matters in which we should be reluctant to disturb the judgment of the state authorities. Accordingly we overrule appellant's constitutional objections to published notice insofar as they are urged on behalf of any beneficiaries whose interests or addresses are unknown to the trustee.

As to known present beneficiaries of known place of residence, however, notice by publication stands on a different footing. Exceptions in the name of necessity do not sweep away the rule that, within the limits of practicability, notice must be such as is reasonably calculated to reach interested parties. Where the names and post office addresses of those affected by a proceeding are at hand, the reasons disappear for resort to means less likely than the mails to apprise them of its pendency.

The trustee has on its books the names and addresses of the income beneficiaries represented by appellant, and we find no tenable ground for dispensing with a serious effort to inform them personally of the accounting, at least by ordinary mail to the record addresses. Certainly sending them a copy of the statute months, and perhaps years, in advance does not answer this purpose. The trustee periodically remits their income to them, and we think that they might reasonably expect that, with or apart from their remittances, word might come to them personally that steps were being taken affecting their interests.

We need not weigh contentions that a requirement of personal service of citation on even the large number of known resident or nonresident beneficiaries would, by reasons of delay, if not of expense, seriously interfere with the proper administration of the fund. Of course, personal service, even without the jurisdiction of the issuing authority, serves the end of actual and personal notice, whatever power of compulsion it might lack. However, no such service is required under the circumstances. This type of trust presupposes a large number of small interests. The individual interest does not stand alone, but is identical with that of a class. The rights of each in the integrity of the fund, and the fidelity of the trustee, are shared by many other beneficiaries. Therefore, notice reasonably certain to reach most of those interested in objecting is likely to safeguard the interests of all, since any objections sustained would inure to the benefit of all. We think that, under such circumstances, reasonable risks that notice might not actually reach every beneficiary are justifiable.

The statutory notice to known beneficiaries is inadequate not because, in fact, it fails to reach everyone, but because, under the circumstances, it is not reasonably calculated to reach those who could easily be informed by other means at hand. However it may have been in former times, the mails today are recognized as an efficient and inexpensive means of communication. Moreover, the fact that the trust company has been able to give mailed notice to known beneficiaries at the time the common trust fund was established is persuasive that postal notification at the time of accounting would not seriously burden the plan.

In some situations, the law requires greater precautions in its proceedings than the business world accepts for its own purposes. In few, if any, will it be satisfied with less. Certainly it is instructive, in determining the reasonableness of the impersonal broadcast notification here used, to ask whether it would satisfy a prudent man of business, counting his pennies but finding it in his interest to convey information to many persons whose names and addresses are in his files. We are not satisfied that it would. Publication may theoretically be available for all the world to see, but it is too much, in our day, to suppose that each or any individual beneficiary does or could examine all that is published to see if something may be tucked away in it that affects his property interests. We have before indicated, in reference to notice by publication that "Great caution should be used not to let fiction deny the fair play that can be secured only by a pretty close adhesion to fact."

We hold the notice of judicial settlement of accounts required by the New York Banking Law is incompatible with the requirements of the Fourteenth Amendment as a basis for adjudication depriving known persons whose whereabouts are also known of substantial property rights. Accordingly, the judgment is reversed, and the cause remanded for further proceedings not inconsistent with this opinion.

10.2.2. A.H. ROBINS CO. v. GRADY, 839 F.2d 198 (4th Cir. 1988)

[A.H.] Robins, a pharmaceutical company, was the manufacturer and marketer of the Dalkon Shield, an interuterine contraceptive device, from 1971 to 1974. Production was discontinued in 1974 because of mounting concerns about the device's safety. Because of the overwhelming number of claims filed against it because of the Dalkon Shield, Robins filed a petition for reorganization under Chapter 11 of the Bankruptcy Code on August 21, 1985.

Mrs. Grady had inserted a Dalkon Shield some years before but thought that the device had fallen out. On August 21, 1985, she was admitted to Salinas Valley Memorial Hospital, Salinas, California, complaining of abdominal pain, fever and chills. X-rays and sonograms revealed the presence of the Dalkon Shield. On August 28, 1985, the Dalkon Shield was surgically removed. Mrs. Grady was discharged from the hospital but not long after returned to her physician, complaining of persistent pain, fever and chills. She was again admitted to the hospital on November 14, 1985, on which admission she was diagnosed as having pelvic inflammatory disease, and underwent a hysterectomy. She blames the Dalkon Shield for those injuries.

On October 15, 1985 (almost two months after Robins filed its petition for reorganization), Mrs. Grady filed a civil action against Robins.

Mrs. Grady then filed a motion in the bankruptcy court, seeking a decision that her claim did not arise before the filing of the petition so that it would not be stayed by the automatic stay provision of the Code. If the claim arose when the Dalkon Shield was inserted into her, the district court reasoned, then it would be considered a claim under the Bankruptcy Code and its prosecution would be stayed. If, however, the claim was found to arise when the injuries became apparent, then it might not be a claim for bankruptcy purposes and the automatic stay provision would be inapplicable.

The bankruptcy court determined that Mrs. Grady's claim against Robins arose **when the acts giving rise to Robins' liability were performed, not when the harm caused by those acts was manifested**. The court rejected Mrs. Grady's contention that the court must look to state law to determine when her cause of action accrued and equate that with a right to payment. It concluded that the court must follow federal law in determining when the claim arose. It held that the right to payment under 11 U.S.C. Sec. 101(4)(A) of Mrs. Grady's claim arose when the acts giving rise to the liability were performed and thus the claim was pre-petition.

We affirm, although our reasoning may vary somewhat from that of the [lower] court(s).

Congress intended that the definition of claim in the Code be as broad as possible, noting that "the bill contemplates that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy. It permits the broadest possible relief in the bankruptcy court."

While the parties agree that the term claim is broadly defined under the Bankruptcy Code, they disagree over whether Mrs. Grady's suit falls within that definition

Mrs. Grady argues that her cause of action against Robins did not accrue until after Robins had filed its reorganization petition and therefore the stay provision is inapplicable. Under California law, she argues that she could not have sued Robins until she knew the nature of her injuries. The argument goes that because she had no right to payment from Robins under state law until she was injured, and since that injury occurred after the reorganization petition was filed, the stay provision of Sec. 362 should not bar her case from its prosecution. While not agreeing that state law necessarily controls, the Future Tort Claimants agree that Mrs. Grady had no pre-petition right of payment from Robins and therefore no claim under the Bankruptcy Code.

Robins argues that Mrs. Grady's claim falls within the definition set out in Sec. 101(4)(A) because the tortious conduct occurred prior to the filing of the petition, and conclude that claim accrual for bankruptcy purposes must be determined in light of bankruptcy law and not state law.

We commence with the proposition that "... except where federal law, fully apart from bankruptcy, has created obligations by the exercise of power granted to the federal government, a claim implies the existence of an obligation created by State law" and that "[b]ankruptcy legislation is superimposed upon rights and obligations created by the laws of the States." So, the bankruptcy Code is superimposed upon the law of the State which has created the obligation. Congress has the undoubted power under the bankruptcy article, U.S. Const. Art. I, Sec. 8 cl. 4, to define and classify claims against the estate of a bankrupt. In the case of a claim as noted above, the legislative history shows that Congress intended that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in bankruptcy.

With those thoughts in mind, we turn to the pertinent parts of the statutes at hand. Section 362(a)(1) provides for an automatic stay of, among other things, judicial action against the debtor "... to recover a claim against the debtor that arose before the commencement of the case under this title." Section 101(4)(A) defines a claim to be 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."

Code Sec. 101(4)(A) provides for a "right to payment" whether or not "such right" is "contingent." BLACK'S LAW DICTIONARY, 5th Ed., 1979, defines "contingent" as follows, and we adopt this definition, there being no indication that Congress meant to use the word in any other sense:

> Contingent. Possible, but not assured; doubtful or uncertain; conditioned upon the occurrence of some future event which is itself uncertain, or questionable. Synonymous with provisional. This term, when applied to a use, remainder, devise, bequest, or other legal right or interest, implies that

no present interest exists, and that whether such interest or right ever will exist depends upon a future uncertain event.

Mrs. Grady's claim, as well as whatever rights the other Future Tort Claimants have, is undoubtedly "contingent." It depends upon a future uncertain event, that event being the manifestation of injury from use of the Dalkon Shield. We do not believe that there must be a right to the immediate payment of money in the case of a tort or allied breach of warranty or like claim, as present here, when the acts constituting the tort or breach of warranty have occurred prior to the filing of the petition, to constitute a claim under Sec. 362(a)(1). It is at once apparent that there can be no right to the immediate payment of money on account of a claim, the existence of which depends upon a future uncertain event. But it is also apparent that Congress has created a contingent right to payment as it has the power to create a contingent tort or like claim within the protection of Sec. 362(a)(1). We are of opinion that it has done so.

Not only do we think that a literal reading of the statute requires the result we have reached, our reading is fortified by other considerations. The broad reading of the word "claim" required by the legislative history and the cases is considerable support. That the legislative history contemplates "the broadest possible relief in the bankruptcy court" also enters our reasoning. If Mrs. Grady and the Future Tort Claimants, who had no right to the immediate payment of money at the time of the filing of the petition, were participants in a Chapter 7 proceeding, the chances are that they would receive nothing, for no compensable result had manifested itself prior to the filing of the petition.

We also find persuasive the fact that the district court probably had authority to achieve the same result by staying Mrs. Grady's suit under 11 U.S.C. Sec. 105(a) in the use of its equitable powers to assure the orderly conduct of reorganization proceedings.

We emphasize, as did the district court, that we do not decide whether or not Mrs. Grady's claim or those of the Future Tort Claimants are dischargeable in this case. Neither do we decide whether or not post-petition claims constitute an administrative expense. We hold only that the Dalkon Shield claim in the case before us, when the Dalkon Shield was inserted in the claimant prior to the time of filing of the petition, constitutes a "claim" "that arose before the commencement of the case" within the meaning of 11 U.S.C. Sec. 362(a)(1).

10.2.3. IN RE JOHNS-MANVILLE CORP., 36 B.R. 743 (Bankr. S.D.N.Y. 1984)

Keene Corp. has put before this Court a motion to appoint a legal representative for asbestos-exposed future claimants in the Manville reorganization case. It is abundantly clear that the Manville reorganization will have to be accountable to future asbestos claimants whose compelling interest must be safeguarded in order to leave a residue of assets sufficient to accommodate a meaningful resolution of the Manville asbestos-related health problem. The term "future asbestos claimants" is defined for these purposes to include all persons and entities who, on or before August 26, 1982, came into contact with asbestos or asbestos-containing products mined, fabricated, manufactured, supplied or sold by Manville and who have not yet filed claims against Manville for personal injuries or property damage. These claimants may be unaware of

their entitlement to recourse against Manville due to the latency period of many years characterizing manifestation of all asbestos related diseases.

Exposure to asbestos dust may result in one of three diseases: asbestosis, a chronic disease of the lungs causing shortness of breath similar to emphysema; mesothelioma, a fatal cancer of the lining of the chest, abdomen or lung, and lung or other cancers. However, it is contended by Manville that it was not until recently that the full extent of the dangers due to asbestos exposure was clarified. Thus, the enhanced safety programs which eventuated because of the new discoveries regarding the damages of asbestos were too late to have any effect on those who had previously been exposed. Accordingly, Manville expects a proliferation of claims in the next 30 years by those previously exposed who will manifest these diseases in this period.

An excursus into the various factors supporting this Court's conclusion that these future claimants possess at the very least a cognizable interest in this reorganization case follows. These factors include the applicability of Code Section 1109(b) regarding parties in interest and those insurance cases holding that a proper trigger for insurance coverage for claims liability is exposure to asbestos. Analysis also focuses on the statistical data relating to the proliferation of future asbestos claims submitted by Manville in support of its petition as well as facts known and agreed to by all parties which dictate a finding that these claimants are parties in interest entitled to representation in this case. This excursus will conclude by exploring the kinds of entities which may be utilized to represent future claimants in these proceedings.

From the inception of this case, it has been obvious to all concerned that the very purpose of the initiation of these proceedings is to deal in some fashion with claimants exposed to the ravages of asbestos dust who have not as of the filing date manifested symptoms of asbestos disease. Indeed, but for this continually evolving albeit amorphous constituency, it is clear that an otherwise economically robust Manville would not have commenced these reorganization proceedings. It is the spectre of proliferating, overburdening litigation to be commenced in the next 20-30 years, which litigation would be beyond the company's ability to manage, control, and pay for, which has prompted this filing.

[The court then reviews statistical estimates of Manville’s future asbestos liability]

Accordingly, a resolution of the interests of future claimants is a central focus of these reorganization proceedings. Any plan emerging from this case which ignores these claimants would serve the interests of neither the debtor nor any of its other creditor constituencies in that the central short and long-term economic drain on the debtor would not have been eliminated. Manville might indeed be forced to file again and again if this eventuated. Each filing would leave attenuated assets available to deal with interests of emerging future claimants. Manville could also be forced into liquidation. The liquidation of this substantial corporation would be economically inefficient in not only leaving many asbestos claimants uncompensated, but also in eliminating needed jobs and the productivity emanating from an ongoing concern. It fosters the key aims of Chapter 11 to avoid liquidation at all reasonable costs.

Indeed, in the final stages of preparation of this opinion, the Seventh Circuit issued its decision in In re UNR Industries, Inc., 725 F.2d 1111, (7th Cir.1984), concerning a decision below denying the appointment of a legal representative for future asbestos claimants. Although the Seventh Circuit held that the issue was not ripe for appellate review, it did declare in dicta the importance of future claimants to any plan emerging from this kind of reorganization. The Seventh

Circuit stated: "If future claims cannot be discharged before they ripen, UNR may not be able to emerge from bankruptcy with reasonable prospects for continued existence as a going concern."

[The Court concludes that future claimants are "parties in interest" because their prepetition exposure to asbestos would trigger insurance coverage under Manville's insurance policies.]

Much of the opposition expressed by the constituencies in this case is concerned with the mechanical difficulties of appointment, i.e., the fairness of a single representative, or the lack of a specifically defined role. The Unsecured Creditors Committee argues that if a representative can be appointed, it should not be a solitary representative, but rather a committee of persons representing this group. The Equity Committee takes the position that if future claims are to be dealt with, the appointment of a legal representative at this time would serve no tangible objective because it is only when Manville seeks an inevitable injunction prohibiting future claimants from asserting their claims against an asset-shielded post-confirmation entity that this representative's function is no longer amorphous. This statement exhibits the Equity Committee's basic belief that a legal representative for future claimants is appropriate to the reorganization process. The Committee only differs from Keene and Manville on the timing of such appointment.

The concept of the appointment of some kind of representative for parties in interest whose identities are yet unknown is not unprecedented. The power to appoint such a representative is inherent in every court.

For the reasons set forth at length herein and in Decision No. 1 on correlated Manville matters, Keene's motion for the appointment of a legal representative is granted.

10.2.4. KANE v. MANVILLE, 843 F.2d 636 (2d Cir. 1988)

This appeal challenges the lawfulness of the reorganization plan of the Johns-Manville Corporation ("Manville"), a debtor in one of the nation's most significant Chapter 11 bankruptcy proceedings. Lawrence Kane, on behalf of himself and a group of other personal injury claimants, appeals from an order [confirming Manville's] Second Amended Plan of Reorganization (the "Plan").

Kane and the group of 765 individuals he represents (collectively "Kane") are persons with asbestos-related disease who had filed personal injury suits against Manville prior to Manville's Chapter 11 petition. The suits were stayed, and Kane and other claimants presently afflicted with asbestos-related disease were designated as Class-4 creditors in the reorganization proceedings.

Kane now objects to confirmation of the reorganization Plan on several grounds: it discharges the rights of future asbestos victims who do not have "claims" within the meaning of 11 U.S.C. § 101(4) (1982), it was adopted without constitutionally adequate notice to various interested parties, [and] the voting procedures used in approving the Plan violated the Bankruptcy Code and due process requirements. We determine that Kane lacks standing to challenge the Plan on the grounds that it violates the rights of future claimants and other third parties, and we reject on the merits his remaining claims that the Plan violates his rights regarding voting.

Prior to its filing for reorganization in 1982, Manville was the world's largest miner of asbestos and a major manufacturer of insulating materials and other asbestos products. Beginning

in the 1960's, scientific studies began to confirm that exposure to asbestos fibers over time could cause a variety of respiratory diseases, including certain forms of lung cancer. A significant characteristic of these asbestos-related diseases is their unusually long latency period. An individual might not become ill from an asbestos-related disease until as long as forty years after initial exposure. Hence, many asbestos victims remain unknown, most of whom were exposed in the 1950's and 1960's before the dangers of asbestos were widely recognized. These persons might not develop clinically observable symptoms until the 1990's or even later.

As a result of the studies linking respiratory disease with asbestos, Manville became the target in the 1960's and 1970's of a growing number of products liability lawsuits. By the early 1980's, Manville had been named in approximately 12,500 such suits brought on behalf of over 16,000 claimants. New suits were being filed at the rate of 425 per month. Epidemiological studies undertaken by Manville revealed that approximately 50,000 to 100,000 additional suits could be expected from persons who had already been exposed to Manville asbestos. On the basis of these studies and the costs Manville had already experienced in disposing of prior claims, Manville estimated its potential liability at approximately $2 billion. On August 26, 1982, Manville filed a voluntary petition in bankruptcy under Chapter 11. From the outset of the reorganization, all concerned recognized that the impetus for Manville's action was not a present inability to meet debts but rather the anticipation of massive personal injury liability in the future.

Because future asbestos-related liability was the raison d'etre of the Manville reorganization, an important question at the initial stages of the proceedings concerned the representation and treatment of what were termed "future asbestos health claimants" ("future claimants"). The future claimants were persons who had been exposed to Manville's asbestos prior to the August 1982 petition date but had not yet shown any signs of disease at that time. Since the future claimants were not yet ill at the time the Chapter 11 proceedings were commenced, none had filed claims against Manville, and their identities were unknown. An Asbestos Health Committee was appointed to represent all personal injury claimants, but the Committee took the position that it represented the interests only of "present claimants," persons who, prior to the petition date, had been exposed to Manville asbestos and had already developed an asbestos-related disease. The Committee declined to represent the future claimants. Other parties in the proceedings, recognizing that an effective reorganization would have to account for the future asbestos victims as well as the present ones, moved the Bankruptcy Court to appoint a legal guardian for the future claimants. The Bankruptcy Court granted the motion, reasoning that regardless of whether the future claimants technically had "claims" cognizable in bankruptcy proceedings, see 11 U.S.C. § 101(4), they were at least "parties in interest" under section 1109(b) of the Code and were therefore entitled to a voice in the proceedings. The Court appointed a Legal Representative to participate on behalf of the future claimants. Additionally, the Court invited any person who had been exposed to Manville's asbestos but had not developed an illness to participate in the proceedings, and two such persons appeared.

The Second Amended Plan of Reorganization resulted from more than four years of negotiations among Manville, the Asbestos Health Committee, the Legal Representative, the Equity Security Holders' Committee, and other groups interested in the estate. The cornerstone of the Plan is the Asbestos Health Trust (the "Trust"), a mechanism designed to satisfy the claims of all asbestos health victims, both present and future. The Trust is funded with the proceeds from Manville's settlements with its insurers; certain cash, receivables, and stock of the reorganized

Manville Corporation; long term notes; and the right to receive up to 20% of Manville's yearly profits for as long as it takes to satisfy all health claims. According to the terms of the Trust, individuals with asbestos-related disease must first try to settle their claims by a mandatory exchange of settlement offers with Trust representatives. If a settlement cannot be reached, the claimant may elect mediation, binding arbitration, or traditional tort litigation. The claimant may collect from the Trust the full amount of whatever compensatory damages he is awarded. The only restriction on recovery is that the claimant may not obtain punitive damages.

The purpose of the Trust is to provide a means of satisfying Manville's ongoing personal injury liability while allowing Manville to maximize its value by continuing as an ongoing concern. To fulfill this purpose, the Plan seeks to ensure that health claims can be asserted only against the Trust and that Manville's operating entities will be protected from an onslaught of crippling lawsuits that could jeopardize the entire reorganization effort. To this end, the parties agreed that as a condition precedent to confirmation of the Plan, the Bankruptcy Court would issue an injunction channeling all asbestos-related personal injury claims to the Trust (the "Injunction"). The Injunction provides that asbestos health claimants may proceed only against the Trust to satisfy their claims and may not sue Manville, its other operating entities, and certain other specified parties, including Manville's insurers. Significantly, the Injunction applies to all health claimants, both present and future, regardless of whether they technically have dischargeable "claims" under the Code. The Injunction applies to any suit to recover "on or with respect to any Claim, Interest or Other Asbestos Obligation." "Claim" covers the present claimants, who are categorized as Class-4 unsecured creditors under the Plan and who have dischargeable "claims" within the meaning of 11 U.S.C. § 101(4). The future claimants are subject to the Injunction under the rubric of "Other Asbestos Obligation," which is defined by the Plan as asbestos-related health liability caused by pre-petition exposure to Manville asbestos, regardless of when the individual develops clinically observable symptoms. Thus, while the future claimants are not given creditor status under the Plan, they are nevertheless treated identically to the present claimants by virtue of the Injunction, which channels all claims to the Trust.

The Plan was submitted to the Bankruptcy Court for voting in June of 1986. At that time relatively few present asbestos health claimants had appeared in the reorganization proceedings. Approximately 6,400 proofs of claims had been filed for personal injuries, which accounted for less than half of the more than 16,000 persons who had filed pre-petition personal injury suits against Manville. Moreover, Manville estimated that there were tens of thousands of additional present asbestos victims who had neither filed suits nor presented proofs of claims. Manville and the creditor constituencies agreed that as many present claimants as possible should be brought into the proceedings so that they could vote on the Plan. However, the parties were reluctant to embark on the standard Code procedure of establishing a bar date, soliciting proofs of claims, resolving all disputed claims on notice and hearing, and then weighting the votes by the amounts of the claims, as such a process could delay the reorganization for many years. To avoid this delay, the Bankruptcy Court adopted special voting procedures for Class 4. Manville was directed to undertake a comprehensive multi-media notice campaign to inform persons with present health claims of the pendency of the reorganization and their opportunity to participate. Potential health claimants who responded to the campaign were given a combined proof-of-claim-and-voting form in which each could present a medical diagnosis of his asbestos-related disease and vote to accept or reject the Plan. For voting purposes only, each claim was valued in the amount of one dollar. Claimants were informed that the proof-of-claim-and-voting form would be used only for voting

and that to collect from the Trust, they would have to execute an additional proof of claim establishing the actual value of their damages.

The notice campaign produced a large number of present asbestos claimants. In all, 52,440 such claimants submitted proof-of-claim-and-voting forms. Of these, 50,275 or 95.8% approved the Plan, while 2,165 or 4.2% opposed it. In addition to these Class-4 claimants, all other classes of creditors also approved the Plan. Class 8, the common stockholders, opposed the Plan.

A confirmation hearing was held on December 16, 1986, at which Manville presented evidence regarding the feasibility and fairness of the Plan. Objections to confirmation were filed by several parties, including Kane. On December 18, 1986, the Bankruptcy Court issued a Determination of Confirmation Issues in which it rejected all objections to confirmation. With respect to Kane's challenge to the Injunction and the voting procedures, the Court relied primarily on its broad equitable powers to achieve reorganizations. Furthermore, the Court found that, based on an extensive liquidation and feasibility analysis presented by Manville at the hearing, the Plan was workable, in the best interests of the creditors, and otherwise in conformity with the requirements of 11 U.S.C. § 1129(a) and (b). The Court entered an order confirming the Plan on December 22, 1986.

A. Standing

The Legal Representative of the future claimants challenges Kane's standing to bring this appeal. The Legal Representative contends that Kane is not directly and adversely affected by the confirmation order and that his appeal improperly asserts the rights of third parties, namely the future claimants. We conclude that Kane is sufficiently harmed by confirmation of the Plan to challenge it on appeal but that his appeal must be limited to those contentions that assert a deprivation of his own rights.

In the present case, Kane, a creditor, has economic interests that are directly impaired by the Plan. His recourse to the courts to pursue damages for his injuries is limited by the settlement procedures mandated by the Trust, he is not entitled to punitive damages, and, ultimately, his recovery is subject to the Trust's being sufficiently funded. Kane might receive more under this Plan than he would receive in a liquidation. However, he might do better still under alternative plans. Since the Second Amended Plan gives Kane less than what he might have received, he is directly and adversely affected pecuniarily by it, and he therefore has standing to challenge it on appeal.

Having determined that Kane may appeal the Bankruptcy Court's confirmation order, we must now decide whose rights Kane will be permitted to assert. It is clear that some of Kane's claims are based exclusively on the rights of third parties. He asserts five claims:

(1) The Injunction violates the Bankruptcy Code because it affects the rights of future asbestos victims who do not have "claims" within the meaning of 11 U.S.C. § 101(4).[4]

(2) The Injunction violates due process because future claimants were given inadequate notice of the discharge of their rights.

(3) The special voting procedures for Class 4 violate due process because present claimants were given inadequate notice of the hearing at which the voting procedures were adopted.

(4) The Class-4 voting procedures violate the Code because persons were permitted to vote before their claims were "allowed" pursuant to 11 U.S.C. § 502 (1982 & Supp. IV 1986), claims were arbitrarily assigned a value of one dollar each for voting purposes, and creditors were denied the opportunity to object to claims.

(5) The Plan fails to meet the requirements of 11 U.S.C. § 1129(a) and (b) because it was not proposed in good faith, it is not in the best interests of all creditors, it is not feasible, and it is not fair and equitable with respect to dissenting classes.

Kane does not dispute that his challenges to the Injunction (claims (1) and (2)) assert the constitutional and statutory rights only of the future claimants. Additionally, we note that claim (3) regarding notice of the voting procedures asserts only third-party rights. Kane was present at the June 23, 1986, hearing at which the voting procedures were adopted and had an opportunity to object, which he concedes that he exercised. Kane's claim with respect to notice of voting procedures is that notice was inadequate only as to present health claimants (other than himself) who were not informed of the special voting procedures and might have wanted to object. The question we must consider is whether on this appeal of the confirmation order, Kane may assert claims of these third parties. We conclude that he may not.

Generally, litigants in federal court are barred from asserting the constitutional and statutory rights of others in an effort to obtain relief for injury to themselves. Though this limitation is not dictated by the Article III case or controversy requirement, the third-party standing doctrine has been considered a valuable prudential limitation, self-imposed by the federal courts.

The prudential concerns limiting third-party standing are particularly relevant in the bankruptcy context. Bankruptcy proceedings regularly involve numerous parties, each of whom might find it personally expedient to assert the rights of another party even though that other party is present in the proceedings and is capable of representing himself. Third-party standing is of special concern in the bankruptcy context where, as here, one constituency before the court seeks to disturb a plan of reorganization based on the rights of third parties who apparently favor the plan. In this context, the courts have been understandably skeptical of the litigant's motives and have often denied standing as to any claim that asserts only third-party rights.

Prudential concerns weigh heavily against permitting Kane to assert the rights of the future claimants in attacking the Plan. First, Kane's interest in these proceedings is potentially opposed to that of the future claimants. Both Kane and the future claimants wish to recover from the debtor for personal injuries. To the extent that Kane is successful in obtaining more of the debtor's assets to satisfy his own claims, less will be available for other parties, with the distinct risk that the future claimants will suffer. Thus, we cannot depend on Kane sincerely to advance the interests of the future claimants. Second, the third parties whose rights Kane seeks to assert are already represented in the proceedings. Though it is true, as Kane points out, that the future claimants themselves are not before the Court, they are ably represented by the appointed Legal Representative. Therefore, it is not necessary to allow Kane to raise the future claimants' rights on the theory that these rights will be otherwise ignored. The Bankruptcy Court appointed the Legal Representative specifically for the purpose of ensuring that the rights of the future claimants would be asserted where necessary. Certainly as between Kane and the Legal Representative, there is no question that the latter is the more reliable advocate of the future claimants' rights, and we may confidently leave that task entirely to him. Finally, and significantly, the Legal Representative has

expressly stated in this appeal that he does not want Kane to assert the future claimants' rights. This is precisely the situation where the third-party standing limitation should apply.

For similar reasons, Kane may not assert the rights of present claimants who he contends were given inadequate notice of the June 1986 hearing at which the special Class-4 voting procedures were adopted. Those Class-4 creditors are in the proceedings and could have objected to the Plan if they had wanted to, but they did not. In fact, the overwhelming majority of Class 4 voted in favor of the Plan. It is not for Kane to insist that other Class-4 members should have received more notice than what apparently satisfies them.

Kane argues that he ought to be permitted at least to challenge the Injunction because his claim is "inextricably bound up with" the rights of the future claimants. Kane reasons that his own recovery from the Trust depends upon Manville's financial stability, which in turn could be jeopardized by a future claimant's successful challenge to the Injunction. If future claimants are not bound by the Injunction, then, Kane predicts, they will sue Manville's operating entities directly, Manville will be unable to meet its funding commitments to the Trust, and Kane will lose his rights to compensation under the Plan. Kane therefore contends that he should be able to test the validity of the Injunction as to the future claimants now so as to avoid a successful challenge detrimental to him in the future.

Though we recognize that future claimants may at some later point attempt to challenge the Injunction, we do not believe that Kane's interests are so "inextricably bound up with" those of the future claimants in such a suit as to warrant third-party standing. Even if we assume that future claimants would at some later time be permitted to advance a position contrary to that taken by the Legal Representative in this litigation and assume further that the future claimants' objections to the Injunction are upheld, matters upon which we express no opinion, Kane has failed to show a sufficient likelihood that he would be harmed by such a successful challenge. The flaw in Kane's analysis is that it assumes that an onslaught of future victims' suits could impair the Trust before Kane is paid. Such is not the case. Kane and the other present claimants are, by definition, currently afflicted with asbestos disease. They may all initiate claims against the Trust immediately after confirmation. Resolution and payment of these claims is expected to take approximately ten years. The bulk of the future victims, in contrast, are not presently afflicted with disease. Many of them will not become ill until well into the 1990's or later. While some of the last of the present claimants may overlap with the first of the future claimants in presenting their damage claims, the claims of these groups will be presented essentially consecutively. By the time enough future claimants develop asbestos-related disease, challenge the Injunction, and, if successful, collect damages directly from Manville to an extent sufficient to impair the long-term funding of the Trust, Kane will have had years to enforce his own claims. Kane's concern that he will be precluded from collecting from the Trust because of future claimants' suits against Manville is therefore too speculative a basis on which to grant third-party standing.

[The Court then rejects Kane’s own claims regarding voting procedures and compliance with the confirmation requirements of the Bankruptcy Code.]

The order of the District Court affirming the Bankruptcy Court's confirmation order is affirmed.

10.2.5. EPSTEIN v. PIPER AIRCRAFT, 58 F.3d 1573 (11th Cir. 1995)

This is an appeal by David G. Epstein, as the Legal Representative for the Piper future claimants (Future Claimants). The sole issue on appeal is whether the class of Future Claimants, as defined by the bankruptcy court, holds claims against the estate of Piper Aircraft Corporation (Piper), within the meaning of § 101(5) of the Bankruptcy Code. After review of the relevant provisions, policies and goals of the Bankruptcy Code and the applicable case law, we hold that the Future Claimants do not have claims as defined by § 101(5) and thus affirm the opinion of the district court.

Piper has been manufacturing and distributing general aviation aircraft and spare parts throughout the United States and abroad since 1937. Approximately 50,000 to 60,000 Piper aircraft still are operational in the United States. Although Piper has been a named defendant in several lawsuits based on its manufacture, design, sale, distribution and support of its aircraft and parts, it has never acknowledged that its products are harmful or defective.

On July 1, 1991, Piper filed a voluntary petition under Chapter 11. Piper's plan of reorganization contemplated finding a purchaser of substantially all of its assets or obtaining investments from outside sources, with the proceeds of such transactions serving to fund distributions to creditors. On April 8, 1993, Piper and Pilatus Aircraft Limited signed a letter of intent pursuant to which Pilatus would purchase Piper's assets. The letter of intent required Piper to seek the appointment of a legal representative to represent the interests of future claimants by arranging a set-aside of monies generated by the sale to pay off future product liability claims.

On May 19, 1993, the bankruptcy court appointed Appellant Epstein as the legal representative for the Future Claimants. This Order expressly stated that the court was making no finding on whether the Future Claimants could hold claims against Piper under § 101(5) of the Code.

On July 12, 1993, Epstein filed a proof of claim on behalf of the Future Claimants in the approximate amount of $100,000,000. The claim was based on statistical assumptions regarding the number of persons likely to suffer, after the confirmation of a reorganization plan, personal injury or property damage caused by Piper's pre-confirmation manufacture, sale, design, distribution or support of aircraft and spare parts. The Official Committee of Unsecured Creditors (Official Committee), and later Piper, objected to the claim on the ground that the Future Claimants do not hold § 101(5) claims against Piper. After a hearing on the objection, the bankruptcy court agreed that the Future Claimants did not hold § 101(5) claims, and, on December 6, 1993, entered an Order Sustaining the Committee's Objection and Disallowing the Legal Representative's Proof of Claim

The sole issue on appeal, whether any of the Future Claimants hold claims against Piper as defined in § 101(5) of the Bankruptcy Code, is one of first impression in this Circuit. Interpretation and application of the Bankruptcy Code is a question of law, to which this Court will apply a de novo standard of review.

Under the Bankruptcy Code, only parties that hold pre-confirmation claims have a legal right to participate in a Chapter 11 bankruptcy case and share in payments pursuant to a Chapter 11 plan.

The legislative history of the Code suggests that Congress intended to define the term claim very broadly under § 101(5), so that "all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case."

Since the enactment of § 101(5), courts have developed several tests to determine whether certain parties hold claims pursuant to that section: the accrued state law claim test, the conduct test, and the prepetition relationship test. The bankruptcy court and district court adopted the prepetition relationship test in determining that the Future Claimants did not hold claims pursuant to § 101(5).

Epstein primarily challenges the district court's application of the prepetition relationship test. He argues that the conduct test, which some courts have adopted in mass tort cases, is more consistent with the text, history, and policies of the Code. Under the conduct test, a right to payment arises when the conduct giving rise to the alleged liability occurred. Epstein's position is that any right to payment arising out of the prepetition conduct of Piper, no matter how remote, should be deemed a claim and provided for, pursuant to § 101(5), in this case. He argues that the relevant conduct giving rise to the alleged liability was Piper's prepetition manufacture, design, sale and distribution of allegedly defective aircraft. Specifically, he contends that, because Piper performed these acts prepetition, the potential victims, although not yet identifiable, hold claims under § 101(5) of the Code.

The Official Committee and Piper dispute the breadth of the definition of claim asserted by Epstein, arguing that the scope of claim cannot extend so far as to include unidentified, and presently unidentifiable, individuals with no discernible prepetition relationship to Piper. Recognizing, as Appellees do, that the conduct test may define claim too broadly in certain circumstances, several courts have recognized "claims" only for those individuals with some type of prepetition relationship with the debtor. The prepetition relationship test, as adopted by the bankruptcy court and district court, requires "some prepetition relationship, such as contact, exposure, impact, or privity, between the debtor's prepetition conduct and the claimant" in order for the claimant to hold a § 101(5) claim.

Upon examination of the various theories, we agree with Appellees that the district court utilized the proper test in deciding that the Future Claimants did not hold a claim under § 101(5). Epstein's interpretation of "claim" and application of the conduct test would enable anyone to hold a claim against Piper by virtue of their potential future exposure to any aircraft in the existing fleet. Even the conduct test cases, on which Epstein relies, do not compel the result he seeks. In fact, the conduct test cases recognize that focusing solely on prepetition conduct, as Epstein espouses, would stretch the scope of § 101(5). Accordingly, the courts applying the conduct test also presume some prepetition relationship between the debtor's conduct and the claimant.

While acknowledging that the district court's test is more consistent with the purposes of the Bankruptcy Code than is the conduct test supported by Epstein, we find that the test as set forth by the district court unnecessarily restricts the class of claimants to those who could be identified prior to the filing of the petition. Those claimants having contact with the debtor's product post-petition but prior to confirmation also could be identified, during the course of the bankruptcy proceeding, as potential victims, who might have claims arising out of debtor's prepetition conduct.

We therefore modify the test used by the district court and adopt what we will call the "Piper test" in determining the scope of the term claim under § 101(5): an individual has a § 101(5)

claim against a debtor manufacturer if (i) events occurring **before confirmation** create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's pre-petition conduct in designing, manufacturing and selling the allegedly defective or dangerous product. The debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct.

In the instant case, it is clear that the Future Claimants fail the minimum requirements of the Piper test. There is no pre-confirmation exposure to a specific identifiable defective product or any other pre-confirmation relationship between Piper and the broadly defined class of Future Claimants. As there is no pre-confirmation connection established between Piper and the Future Claimants, the Future Claimants do not hold a § 101(5) claim arising out of Piper's prepetition design, manufacture, sale, and distribution of allegedly defective aircraft.

For the foregoing reasons, we hold that the Future Claimants do not meet the threshold requirements of the Piper test and, as a result, do not hold claims as defined in § 101(5) of the Bankruptcy Code.

10.2.6. IN RE FAIRCHILD AIRCRAFT CORP., 184 B.R. 910 (Bankr. W.D. Tex. 1995)

Fairchild Aircraft Incorporated ("FAI") filed its Complaint for Declaratory and Injunctive Relief in the bankruptcy case of Fairchild Aircraft Corporation ("FAC"). [FAI and defendants have filed] cross-motions for summary judgment.

The issue of future claims in bankruptcy has bedeviled the federal courts for many years now. What happens after a bankruptcy plan disposes of all the assets of a debtor and, years later, someone suffers an injury alleged to have arisen from a defective product produced by the prepetition debtor? Does the injured party have a claim against the successor entity for damages, unaffected by the bankruptcy process? Or may bankruptcy alter or even eliminate those claims before they even mature into an injury? That is the issue with which this decision struggles and attempts to resolve.

The facts surrounding this matter span over a decade. Fairchild Aircraft Corporation manufactured and sold commuter aircraft, one a 19-seat passenger aircraft sold to civilians as a Metro III and to the military as the C-26, and the other a smaller aircraft sold as the Merlin II and III or the Fairchild 300. This case concerns the crash of one these smaller aircraft, a Fairchild 300. FAC stopped production of the Fairchild 300 in 1982. FAC continued to sell the aircraft as late as 1985, because it held several of the airframes in inventory. It is undisputed that the aircraft in question in this case was manufactured no later than 1982 and sold no later than 1985 — five years before FAC's later chapter 11 bankruptcy.

FAC filed for chapter 11 relief on February 11, 1990. Shortly after the filing, a chapter 11 trustee was appointed (the "Trustee"), with full authority to operate the debtor's business. The Trustee, Bettina M. Whyte, decided that reorganization was not a viable option for the estate, and solicited a buyer for the company's assets, which she proposed to sell as a going concern. On

August 14, 1990, the Trustee entered into an asset purchase agreement with a group of investors who formed a corporation for the purpose of the acquisition, called appropriately enough Fairchild Acquisition, Inc. FAI was to pay $5 million in cash and was to assume liability for FAC's secured debt to Sanwa Business Credit, in the range of $36 million. The estate was to retain some cash, its estate causes of action (including preference actions), and a share of an anticipated tax refund. The asset purchase agreement also contained the following provision, which the acquiring entity maintains was an essential element of the bargain and induced the seller to purchase the assets for as much as it did:

> Purchaser shall not assume, have any liability for, or in any manner be responsible for any liabilities or obligations of any nature of Seller or the Trustee, including without limiting the generality of the foregoing: ... (ii) any occurrence or event at any time which results or is alleged to have resulted in injury or death to any person or damage to or destruction of property (including loss of use) or any other damage (regardless of when such injury, death or damage takes place) which was caused by or allegedly caused by (A) any hazard or alleged hazard or defect or alleged defect in manufacture, design, materials or workmanship...

The sale took place as part of the confirmation of the Trustee's First Amended Plan of Reorganization and was of course subject to the approval of the bankruptcy court. On September 17, 1990, the court confirmed the Trustee's Plan and the asset sale agreement which was its central feature. The confirmation order expressly stated that the assets were sold "free and clear of all liens, claims, and encumbrances," except for those liens and encumbrances assumed by the buyer under the plan. The order further stated that the purchaser would not "assume, have any liability for, or in any manner be responsible for any liabilities or obligations of any nature of Debtor, Reorganized Debtor, the Trustee or the Fiscal Agent." Finally, the order enjoined and stayed "all creditors, claimants against, and persons claiming or having any interest of any nature whatsoever" from "pursuing or attempting to pursue, or commencing any suits or proceedings at law, in equity or otherwise, against the property of the Debtor's estate ... the proceeds of the sale ... or any other person or persons claiming, directly or indirectly, including the Purchaser under the Asset Purchase Agreement ..."

The court found that the consideration to be paid by FAI (the cash and the assumption of secured debt) was "fair and adequate and fully representative of the maximum value that can be realized at this time for Debtor's Property." The court also made a finding that the notice provided concerning the plan and disclosure statement was reasonable under the circumstances. The Trustee had published notice of the disclosure statement, plan of reorganization and confirmation hearing in the Weekly News of Business Aviation, and in two local newspapers, the San Antonio Light and the San Antonio Express-News.

The Trustee made no provision in her plan for claimants in the position of these defendants. Indeed, the debtor had not even listed any of the owners or operators of FAC aircraft in its bankruptcy schedules, though their identities were available and ascertainable from the records of FAC. The Trustee made no particular effort to reach these persons in the plan process, and the plan itself made no particular provision for these persons.

On April 1, 1993, a Fairchild 300 aircraft, originally sold and manufactured by FAC crashed near Blountville, Tennessee. Four individuals lost their lives. Multiple lawsuits were of course filed on the heels of this crash, in both federal and state courts in Georgia, Tennessee and South Carolina. Three of the plaintiffs were persons suing both individually and on behalf of estates of the individuals killed in the aircraft crash. The plaintiffs also included Eastern Foods, Inc. and Hooters of America, Inc., the owners of the airplane, as well as Insurance Company of North America, the owner's insurance carrier.

The plaintiffs named FAI as one of the defendants, alleging that the aircraft was defectively manufactured by FAC, and that FAI is now liable for the manufacture and sale of a defective product on a successor liability theory. FAI filed this adversary proceeding as a preemptive strike, seeking an order for declaratory and injunctive relief premised on the provisions of the plan, the asset purchase agreement, and the court's order confirming the plan. As such, the plaintiffs in the products liability lawsuits find themselves as defendants in this action for declaratory relief.

The legal issues presented can be stated simply. FAI claims that the provisions of the asset purchase agreement and order confirming the plan "cleansed" the property acquired of any liability for the acts of FAC, including any successor liability growing out of the sale of those assets to FAI by the trustee of FAC's bankruptcy. FAI says that the sale was free and clear of this sort of liability, and that the bankruptcy court should here so declare. FAI also contends that any lawsuit to force liability on FAI based upon its acquisition of assets would violate the bankruptcy court's injunction contained in the confirmation order, and asks the court to enforce that injunction.

FAI would like to stop the defendants in their tracks without ever having to defend against a successor liability lawsuit. It is not hard to understand why. Even if FAI believes the successor liability allegation to have little merit (and that is its position), it must still incur the cost of defense and risk the uncertainty of litigation. Moreover, there are still other FAC aircraft out there, and if another one crashes, an adverse outcome in this litigation could all but assure an adverse outcome in other litigation as well. Rather than endure these risks, FAI would like to rely on what it believes to have been the effective protections built into the court-supervised sale process, protections for which it believes it bargained. If those protections prove to be worthless, then it will not have received the benefit of its bargain, a result with consequences reaching far beyond this litigation not only for FAI but also for bankruptcy estates in general.

[W]e must first be sure to understand the nature of the particular claim with which we are here presented. Then we must next determine whether it is in fact a "bankruptcy claim" within the meaning of section 101(5) of the Code. If it is, then we must determine whether the bankruptcy process could have affected this claim. Finally, we must decide whether the bankruptcy process employed in this case did in fact affect this claim in a manner such as to cut off the ability of these defendants to maintain their action against FAI. We turn to the first question, an understanding of the nature of this claim.

Successor liability has its antecedents in corporate law. In corporate law, the general rule has always been that the transfer of assets from one company to another does not pass on the debts or liabilities of the transferor, including liability for torts or products liability actions. The general rule is not absolute, and four exceptions have been traditionally recognized. A successor by purchase may be held liable for the debts or liabilities of its predecessor where: (1) there is an express or implied assumption of liability; (2) the transaction amounts to a consolidation, merger

or similar restructuring of the two corporations; (3) the purchasing corporation is a "mere continuation" of the seller; or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts. In recent years, a few courts have recognized a fifth exception, springing essentially from the nature of the defect and the product in question.

Regardless the exception, successor liability does not create a new cause of action against the purchaser so much as it transfers the liability of the predecessor to the purchaser. The nature of the liability itself does not change. Thus, while successor liability may give a party an alternative entity from whom to recover, the doctrine does not convert the claim to an in rem action running against the property being sold. Nor does the claim have an existence independent of the underlying liability of the entity that sold the assets.

If this "claim" is in fact one properly characterized as a "claim" within the meaning of the Bankruptcy Code (i.e., a "bankruptcy claim"), then the sale of assets via the bankruptcy process could certainly transfer the assets free of any such in personam bankruptcy claims against the estate. What is more, we know from the nature of successor liability itself that a successor cannot legitimately be presumed to have "assumed" claims that were already being handled in the bankruptcy process when the successor purchased assets out of a bankruptcy estate. For this reason, we must turn our focus to what sort of claim, if any, the defendants can be said to have had against FAC, the predecessor entity. Here, importantly, we are speaking of claim in the bankruptcy sense, for it is only if the claims of the defendants can properly be said to have been the subject of the bankruptcy process that we can maintain that the bankruptcy court had any authority to issue orders affecting their rights.

Courts have struggled to give content to the extraordinarily broad definition of claim found in the Code, with an eye on the impact that bankruptcy now has on a given creditor who is held to have a "claim" in the bankruptcy case. On the one hand, all recognize that Congress fully intended to move away from the relatively restricted definition in the Act, toward a concept that would permit the bankruptcy process to accord broad and complete relief to debtors. After all, what's the point in having a remedy for financial restructuring that leaves a substantial portion of the debt outside the process? By the same token, however, more and more courts and commentators also recognize that the concept must have some limits. Due process, fundamental fairness, and the limits of subject matter jurisdiction all seem to mark the outer boundaries of the concept. Courts are still struggling with a formulation that reconciles these competing considerations.

With provability eliminated from the Code's definition of claim, and with even contingent, unliquidated, unmatured claims now swept into the bankruptcy process, courts have quickly discovered that "future claims" of a kind that never would have passed muster under [the Bankruptcy Act] could conceivably be treated in bankruptcy today. Certainly claims arising from injuries that manifest themselves any time before confirmation come within the scope of the definition, even if both liability and damages are contested and unresolved. And claims that hinge on a contingency are also included, even if the contingency has yet to occur. Courts have also found that claims that arise from some prepetition conduct of the debtor causing injury to the claimant, but which do not even manifest themselves until after the bankruptcy, may be claims treatable in the bankruptcy process. [citing Johns-Manville Corp. and Grady v. A.H. Robins]. Each time courts revisit the issue, they find themselves having to reconfront the competing concerns of evincing Congress' intentions that the definition be given broad scope to assure that bankruptcy is an effective remedy, on the one hand, and of assuring that the entire process is fair (to say nothing

of constitutional), on the other. The broader the reach, the greater the impact on notions of fundamental fairness. The more circumscribed by court-erected limitations, the greater the risk of doing violence to congressional intent.

[The court reviews prior decisions on what constitutes a “claim” – (1) the “accrual” test, which looks at whether the claim “accrued” for statute of limitations purposes prepetition or post-petition; (2) the “conduct” test, which asks whether the debtor’s pre-petition or post-petition conduct caused the injury; and (3) the “relationship” test, which is described below.]

Concerned about the broad sweep of the "conduct" test and its adverse impact on notions of fundamental fairness, several courts have devised yet a third approach, characterized as the "relationship" or "conduct plus" test. The "relationship" test looks not merely to the conduct of the debtor, but to whether the purported claimant had a specific and identifiable relationship with the debtor prepetition. It is not enough that the claimant's injury can be traced to the debtor's pre-bankruptcy conduct. The court must also inquire into the relationship of the debtor and the alleged claimant. A claim for bankruptcy purposes will exist only where "some prepetition relationship, such as contact, exposure, impact, or privity, between the debtor's prepetition conduct and the claimant" is established.

[T]he Fifth Circuit recently adopted a version of the "relationship" test in *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268 (5th Cir.1994). In *Lemelle*, the plaintiff brought a wrongful death suit against Universal Manufacturing Corporation, an entity ultimately determined to be a successor to Winston Industries, Inc., the debtor. The suit was based upon Winston's defective design and manufacturing of a mobile home in 1970, twelve years prior to the debtor's bankruptcy. Universal moved for summary judgment on grounds that it was not the successor in interest and that the liability had been "discharged" in Winston's bankruptcy. [T]he Fifth Circuit [adopted a] variant of the relationship test. Though *Lemelle* clearly requires as a threshold a showing of prepetition "relationship," the court declined to flesh out the contours of that concept. In fact, a relationship established might nonetheless not be enough to make the claim a bankruptcy claim. The Fifth Circuit thus accurately senses that honoring the tension between fundamental fairness and congressional intent is far from mechanical.

In leaving many doors still open, the Fifth Circuit has also left at least some hints about which direction it might take in a future case. Clearly, the court recognized the need, positively expressed in the Code's definition of "claim" that the process be as all-encompassing as possible in order to achieve a meaningful result. Especially in the reorganization context, the more loose ends left unattended by the process, the less likely the process is to achieve an effective result. That is precisely why the drafters employed such far-reaching language in section 101(5).

Yet it is precisely that phrase, "the broadest possible relief" that suggests where the outer boundaries might be. We are limited to the possible. That may not sound like much of a limitation at first blush, but in fact it is a very effective, very practical statement of parameters. For what is possible is defined at least in part by what is fair. And Lemelle gives a sign or two that the Fifth Circuit senses that this is how we go about finding the limitations on the concept of bankruptcy claim. Specifically addressing the scenario in which both the injury and the manifestation of the injury take place simultaneously at a time after the confirmation of the debtor's plan, even though arising out of prepetition conduct, the court said:

> at a minimum, there must be evidence that would permit the debtor to identify, during the course of the bankruptcy proceedings, potential victims and thereby permit notice to these potential victims of the pendency of the proceedings.

What kinds of claims can be bankruptcy claims, then? Perhaps whatever claims that it is possible to handle fairly in the bankruptcy process.

This is an entirely new and different approach to the problem of future claims. It starts, true enough, by looking at the events that give rise to the claim, but it finishes by focusing less on the claim and more on the claimant. At the beginning of the inquiry, we are attentive to the clearly expressed intentions of the statute that the bankruptcy process sweep broadly and completely, to maximize the possibility of achieving an effective result. But by the end of the inquiry, we find ourselves most attentive to the other side of the dialectic, that of assuring that the process, whatever else it be, be fair.

We ought to be able to first give effect to the broadest definition of what might be a claim, then focus on what is possible in order to determine what is in fact a bankruptcy claim in any given case.

We ought here to retrace our steps a bit, then. On the one hand, bankruptcy claims encompass the "broadest" relief for the estate. On the other, bankruptcy claims can go no further than what is "possible." Placed side by side, thesis and antithesis, we struggle Hegelian-style toward a synthesis. We turn first to how "broad" ought to be the concept of claim.

Taken at its word, the definition of claim implies the inclusion of every type of liability which could be traced to prepetition conduct. The definition includes all legal obligations no matter how remote or contingent. These modifying terms will operate to sweep up virtually every liability which could be traced to the debtor's prepetition past. The legal obligation need only be slight, and need not be a present interest. It might merely be not assured and doubtful or uncertain. The definition easily includes liabilities which are afar off and conditioned upon future events. And the statute's legislative history instructs that the definition of claim include all legal obligations, no matter how remote or contingent. The term could thus encompass not only the types of liabilities in question here, or even those discussed in Lemelle, but even claims one could only imagine happening. What is more, they might not even be "legal" obligations as of the date of the filing.

The only natural limit is that "bankruptcy claim" by definition can extend no further than the confirmation of a debtor's plan (in a chapter 11 case). Claims that have their origin after that artificial date are deemed to be the post-confirmation debtor's problem. The conduct formulation of the test found in the case law helps to remind us that the intended target of the reorganization process are those claims that have something to do with the debtor's pre-bankruptcy existence (or its in-bankruptcy experience). But the scope of the concept remains extraordinarily broad nonetheless, thanks to the qualifying terms in the statute, and the further explanations contained in the legislative history. What is swept up by the "broadest" aspect of the dialectic are simply whatever kinds of liabilities that have their antecedents in the debtor's pre-bankruptcy history.

In the case of a company such as Fairchild Aircraft Corporation, one of the many kinds of remote or contingent liabilities that of necessity arose out of its pre-bankruptcy activities was that associated with the possibility that at least one of the planes that it manufactured might fall out of the sky, for reasons ultimately attributable to something FAC did. Cigarette manufacturers face

the same potential when they sell people tobacco products. Asbestos manufacturers "incurred" liability in the bankruptcy sense just by making products out of asbestos. In this analysis, it does not much matter whether the injury "occurs" before the bankruptcy filing or after confirmation. The definition of claim draws no such distinction and, for purposes of this aspect of the dialectic, we need not either. About all that we need do is to locate the source, the cause, the responsibility in the debtor's pre-bankruptcy past.

That establishes the thesis. Now for the antithesis. What sort of relief is "possible" in the bankruptcy context? Or to state it in a fashion more consistent with the tenor of the case law, what sort of relief is "not possible?"

"Claim" ought not to do what is "not possible" in a court of law — it may not authorize courts to ride roughshod over due process and notions of fundamental fairness, for example. The bankruptcy process, after all, has its antecedents in equity. Courts have an affirmative duty to assure that the process, within the confines of the law, achieve a fair and equitable result.

The immediate limitation this suggests is that, of necessity, no treatment which violates the due process rights of a claimant can be permitted to stand, regardless the purported breadth of the definition of bankruptcy claim (to say nothing of the breadth of provisions such as section 1141(c)).

Even more important for our analysis, in addition to these constitutional constraints (which would be applicable regardless of the dialectic), the bankruptcy process ought to be fair in the broader, equitable sense. Not every conceivable obligation finding its source in the debtor's pre-bankruptcy past is necessarily an obligation that can be fairly handled by the bankruptcy process. The *Lemelle* court cautioned that a debtor in a given case will have to be able to sufficiently identify contingent liabilities such that the holders of such claims could be afforded some degree of procedural fairness before a court will call the claim a bankruptcy claim, i.e., one which not only has its antecedents in the debtor's pre-bankruptcy past but which also can be dealt with fairly by the bankruptcy process.

This brings us to the critical question left unanswered by *Lemelle*. Just what is capable of resolution in the bankruptcy process? The answer lies in the extent to which it is possible to deal with a given category of claims in a fashion that assures fundamental fairness in treatment.

Notions of fundamental fairness will not normally tolerate a potential claimant's rights being affected without its having had any way of participating in or being involved in the process. Yet, we also know, from looking at other kinds of proceedings outside of bankruptcy that courts can and do affect the rights of parties not before the court.

Class actions provide us with the most telling parallel. [The court discusses class action cases binding future parties through the appointment of a class representative]. Bankruptcy too seeks to achieve an "efficient and fair resolution" of what often parallels large-scale litigation, especially in the mass tort bankruptcies. That resolution might indeed "outweigh" the gains that might be obtained by some form of individualized noticing — precisely because the benefits in the bankruptcy context are conjectural. The alternative, after all, in the bankruptcy context, would be the liquidation of the enterprise, resulting in no compensation at all to any of the victims. The rights of such claimants might be "better served" by assuring that "fair and just recovery procedures [are] made available to these claimants." And if such procedures can be crafted in the class action context, they ought to be capable of implementation in bankruptcy as well.

To be sure, some sort of notice is indicated —mandated, in fact — by the case law in class actions. Publication notice of the broadest sort feasible is certainly a common feature in many bankruptcy cases, as well, especially those involving mass tort victims. In our particular case, one might even imagine notices posted at the door of every Fairchild aircraft, advising that any claims arising out of the manufacture of the aircraft are to be (have been?) dealt with in bankruptcy. But that the notice might not in fact reach a given claimant in time for that claimant to do anything about it was not, of itself, decisive in the [class action] case. That "defect" might be offset by other societal needs, especially where it was clear that such notice, if given, "would probably do no good." Further, the "defect" might be counterbalanced by "vigorous and faithful vicarious representation." For persons whose injuries have yet to "manifest" themselves, such notice would be far from perfect. But under the circumstances, and given the countervailing social policy of assuring at least some payment for the broadest range of persons, that might be all the notice required. The same can be said of bankruptcy cases.

The more important consideration is whether it is possible to design "fair and just recovery procedures" in the bankruptcy process, as it was evidently possible to do in the class action context. Many of the mass tort bankruptcy cases have given heed to the class action model, employing a "class representative" for the members of the class, including those members who might not even know they are members. Such a representative was appointed in both Johns-Manville and A.H. Robins. A similar representative was appointed in the [Agent Orange class action] litigation, and the employment of that device was a critical factor in the court's ultimate conclusion that the process employed was fundamentally fair and did not violate the due process rights of the claimants there.

Bankruptcy shares common features with this sort of class action. Here too the law permits the putatively liable party to come down quickly to the bottom line, estimate the total liability, make appropriate provision for it, and thereby be permitted to move on with its economic life. Here too, the interests of some creditors may well have to be handled not directly (because practical realities make that impossible) but indirectly, via a representative.

Bankruptcy almost always involves at least some creditors whose individual identities might not be known to the debtor, even though the debtor can identify a known group of likely claimants who, within a statistical certainty, will be (or already have been) injured by the debtor's prepetition conduct. The critical question always for such types of claimants is affording them a meaningful opportunity to participate in the process, such that the process can actually effectuate meaningful relief for the debtor. The debtor in restructuring its financial affairs will want to take account of these anticipated liabilities along with its other, more quantifiable liabilities lest the process be doomed to failure from the start, for the anticipated liabilities are no less real for being less quantifiable. But meaningful relief for the debtor must of necessity affect the collection rights of future claimants. So long as those rights are affected in a manner that comports with notions of fundamental fairness, the debtor ought to be able to bind those claimants, in much the same way as members of a class in a class action may be bound. If the debtor can achieve this end, then the claims ought to be thought of as "bankruptcy claims," and ought to be bound by the bankruptcy process.

We have posited the "legal representative" as one device for assuring fundamental fairness for future claimants. It may not be the only way, of course. Each case will turn on its own facts. We know, for example, that a non-party could be bound to a prior judgment, where the non-party's

interests have been represented in the proceeding by a person with similar rights or interests. A non-party may also be bound to the issues resolved in a prior suit where the non-party's interests were "so closely aligned with the interests" of a party that the non-party's interests can be held to be "virtually represented." The point is not that one or another method is guaranteed to achieve fundamental fairness, but rather that whatever method is chosen to meet the peculiar circumstances must, in the process, achieve fundamental fairness in the manner in which it deals with remote claims such as these.

We thus reach the denouement of our dialectic. It is indeed possible to synthesize the antipodal notions of broad scope and fair treatment to arrive at a sensible and workable definition of bankruptcy claim. Congress was not, after all, posing an impossible conundrum. Instead, Congress sought and succeeded in devising a definition of claim that would both assure an effective mechanism for reorganization and a fair treatment of creditor interests. But the selfsame definition is also restricted to those claims to which it is also possible to accord fair representation of their interests in the course of the case. The debtor must demonstrate to the bankruptcy court that it had sufficient knowledge of the nature and scope of the claims to be obligated to fairly anticipate having to provide for them as part of its financial restructuring, that these types of claims were indeed bankruptcy claims because it was practically and equitably possible to deal with such liabilities as claims, and that such claims were in fact dealt with fairly and responsibly. This is what we take the Fifth Circuit to have meant when it insisted that the debtor demonstrate a prepetition "relationship" with the potential victims such that it was possible for the court to practically deal with the claimants in the bankruptcy.

There can be no doubt that the general policy of assuring a debtor's "fresh start," as well as the reorganizational policy of "saving going concern value" are furthered by the broadest definition of the term claim. Bankruptcy is meant to separate the past and the future of an enterprise for those purposes. Claims attributable to yesterday's activities ought to be satisfied out of existing assets, which will in turn enable a business with positive value to move onward without the burden of its prior blunders. By the same token, as it is the debtor that is the intended beneficiary of this policy, it is also appropriate that substantial responsibility be imposed on the debtor to assure fair and equitable treatment of the creditors whose interests will necessarily be affected.

We now turn to that critical inquiry. In the present case, there is no dispute that the injuries alleged arose out of the prepetition conduct of FAC. The basis for successor liability is the debtor's manufacture and sale of allegedly defective aircraft, which must have occurred at least five years prior to the bankruptcy (if it occurred at all). Nor is there any dispute that the injuries occurred post confirmation and that the manifestation of those injuries occurred simultaneously with the injury. The undisputed facts also show that the debtor (actually in this case, the trustee) did not take the necessary steps to establish these liabilities as claims in the bankruptcy proceeding either directly or indirectly (though perhaps they could have been included). No claims were ever filed on behalf of these persons, **and at no time did any party attempt to have a legal representative appointed**. These claimants could have been claimants in the bankruptcy sense, for the debtor certainly had enough information to know that some of its planes might fall out of the sky, and that people injured or killed in those crashes would likely attempt (perhaps justifiably) to hold FAC responsible. The debtor could have, with a fair amount of precision, even estimated the number of such aircraft likely to crash, and the number of persons likely to be injured as a result. And the trustee could have then taken the steps that were taken in A.H. Robins and Johns-Manville

to appoint a legal representative for these interests whose task it would have been to assure that appropriate steps were taken to protect or provide for those interests.

Because these steps were not taken, though they could have been, these alleged claims cannot, at the end of the day, be treated as "bankruptcy claims." To reiterate our dialectic, while the claims fit the thesis, they falter on the antithesis.

The court's conclusion that the defendants did not have bankruptcy claims leads to the further conclusion that the bankruptcy court's order confirming the plan could not have affected these liabilities. Sections 1141(a), 1141(c) and 1141(d) could have provided the relief suggested by FAI, but those sections all have one limiting characteristic in common. Before one can be bound by a plan, have property transferred free and clear or their interest or be subject to the debtor's discharge, the person must hold a "bankruptcy claim." Since, these liabilities cannot properly be considered claims, these sections have no effect on the liabilities.

The order of sale did not insulate FAI, and this court lacked the jurisdiction to enjoin these claimants, because they did not hold "bankruptcy claims" as defined in this decision. Summary judgment must be denied to plaintiffs, and entered in favor of defendants. An order will be entered consistent with this decision.

10.2.7. IN RE GROSSMAN'S INC., 607 F.3d 114 (3d Cir. 2010)

This Court's Internal Operating Procedure provides:

> It is the tradition of this court that the holding of a panel in a precedential opinion is binding on subsequent panels. Thus, no subsequent panel overrules the holding in a precedential opinion of a previous panel. Court en banc consideration is required to do so.

We adhere strictly to that tradition. It is only on a rare occasion that we overrule a prior precedential opinion. We assemble en banc to consider whether this is such an occasion.

In 1977, Appellee Mary Van Brunt, who was remodeling her home, purchased products that allegedly contained asbestos from Grossman's, a home improvement and lumber retailer. In April 1997, Grossman's filed petitions under Chapter 11 of the Bankruptcy Code.

At the time of the [bankruptcy], "Grossman's had actual knowledge that it had previously sold asbestos containing products such as gypsum board and joint compound; Grossman's knew of the adverse health risks associated with exposure to asbestos; it was aware that asbestos manufacturers had been or were being sued by asbestos personal-injury claimants; it was aware that producers of both gypsum board and joint compound were being sued for asbestos-related injuries; and it was not aware of any product liability lawsuits based upon alleged exposure to asbestos-containing products that had been filed against [it]."

Grossman's proceeded to provide notice by publication of the deadline for filing proofs of claim. There was no suggestion in the publication notice that Grossman's might have future asbestos liability. Grossman's Chapter 11 Plan of Reorganization purported to discharge all claims that arose before the Plan's effective date. The Bankruptcy Court confirmed the Plan of Reorganization in December 1997.

Ms. Van Brunt did not file a proof of claim before confirmation of the Plan of Reorganization because, at the time, she was unaware of any "claim" as she manifested no symptoms related to asbestos exposure. It was only in 2006, almost ten years later, that Ms. Van Brunt began to manifest symptoms of mesothelioma, a cancer linked to asbestos exposure. She was diagnosed with the disease in March 2007.

Shortly after her diagnosis, the Van Brunts filed an action for tort and breach of warranty in a New York state court against JELD-WEN, the successor-in-interest to Grossman's, and fifty-seven other companies who allegedly manufactured the products that Ms. Van Brunt purchased from Grossman's in 1977. Ms. Van Brunt conceded that she did not know the manufacturer of any of the products that she acquired from Grossman's for her remodeling projects in 1977. After the Van Brunts filed their suit, JELD-WEN moved to reopen the Chapter 11 case, seeking a determination that their claims were discharged by the Plan. Ms. Van Brunt died in 2008 while the case was pending. Gordon Van Brunt has been substituted in her stead as the representative of her estate.

The Bankruptcy Court concluded that the 1997 Plan of Reorganization did not discharge the Van Brunts' asbestos-related claims because they arose after the effective date of the Plan. In so holding, the Bankruptcy Court relied on our decisions in [*Matter of M. Frenville Co.*, 744 F.2d 332 (3d Cir.1984) ("*Frenville*")].

In 1980, M. Frenville Co. [and its two principals filed bankruptcy] Later that year, four banks filed a lawsuit in a New York state court against the company's former accountants, Avellino & Bienes ("A & B"), alleging that A & B negligently and recklessly prepared the company's pre-petition financial statements and seeking damages for their alleged losses exceeding five million dollars. A & B filed a complaint in the bankruptcy court seeking relief from the automatic stay in order to implead Frenville as a third-party defendant in order to obtain indemnification or contribution under New York law. The bankruptcy court, affirmed by the district court, held that the automatic stay barred A & B's action.

We reversed, holding that because the automatic stay applied only to claims that arose pre-petition, under New York law A & B did not have a right to payment for its claim for indemnification or contribution from Frenville until after the banks filed their suit against A & B. It followed that A & B's claim against Frenville arose post-petition even though the conduct upon which A & B's liability was predicated (negligent preparation of Frenville's financial statements) occurred pre-petition. It followed that the automatic stay was inapplicable. We emphasized that the "crucial issue" was when the "right to payment" arose as determined by reference to the New York law that governed the indemnification claim.

This court subsequently summarized *Frenville* as holding that "the existence of a valid claim depends on: (1) whether the claimant possessed a right to payment; and (2) when that right arose" as determined by reference to the relevant non-bankruptcy law. The *Frenville* test for determining when a claim arises has been referred to as the "accrual test."

The applicable New York law provides that a cause of action for asbestos-related injury does not accrue until the injury manifests itself. The Bankruptcy Court therefore reasoned that the Van Brunts had no "claim" subject to discharge in 1997 because Ms. Van Brunt did not manifest symptoms of mesothelioma—and thus the New York cause of action did not accrue—until 2006.

In the case before us, the District Court and Bankruptcy Court correctly applied the accrual test in holding that the Van Brunts' tort claims were not discharged by the Plan of Reorganization. According to *Frenville*, the claims arose for bankruptcy purposes when the underlying state law cause of action accrued. The New York tort cause of action accrued in 2006 when Ms. Van Brunt manifested symptoms of mesothelioma. The claims were therefore post-petition under *Frenville*.

The question remains, however, whether we should continue to follow *Frenville* and its accrual test. We have recognized that "[s]ignificant authority [contrary to *Frenville*] exists in other circuits...." A sister circuit has described our approach in *Frenville* as "universally rejected." The courts of appeals that have considered *Frenville* have uniformly declined to follow it. At least one bankruptcy court has stated that *Frenville* "may be fairly characterized as one of the most criticized and least followed precedents decided under the current Bankruptcy Code." In addition to the cases cited above, JELD-WEN cites numerous district court and bankruptcy court decisions that have declined to follow *Frenville*. The criticism has been echoed by commentators.

Notwithstanding what appears to be universal disapproval, we decide cases before us based on our own examination of the issue, not on the views of other jurisdictions. Nevertheless, those widely held views impel us to consider whether the reasoning applied by our colleagues elsewhere is persuasive.

Courts have declined to follow *Frenville* because of its apparent conflict with the Bankruptcy Code's expansive treatment of the term "claim." [the court then reviews the statute, the legislative history, and prior Supreme Court precedent on the broad sweep of the term “claim.”]

The *Frenville* court focused on the "right to payment" language in § 101(5) and, according to some courts, "impos[ed] too narrow an interpretation on the term claim," by failing to give sufficient weight to the words modifying it: "contingent," "unmatured," and "unliquidated." The accrual test in *Frenville* does not account for the fact that a "claim" can exist under the Code before a right to payment exists under state law.

We are persuaded that the widespread criticism of *Frenville's* accrual test is justified, as it imposes too narrow an interpretation of a "claim" under the Bankruptcy Code. Accordingly, the *Frenville* accrual test should be and now is overruled.

Our decision to overrule *Frenville* leaves a void in our jurisprudence as to when a claim arises. That decision has various implications. One such implication involves the application of the automatic stay provided in § 362 of the Bankruptcy Code which operates to stay the commencement or continuation of any "action or proceeding" that was or could have been commenced against the debtor.

Principal among the effects of the determination when a claim arises is the effect on the dischargeability of a claim. Under 11 U.S.C. § 1141(d)(1)(A) of the Code, the confirmation of a plan of reorganization "discharges the debtor from any debt that arose before the date of such confirmation ...." A "debt" is defined as liability on a "claim," which in turn is defined as a "right to payment.” This is consistent with Congress' intent to provide debtors with a fresh start, an objective, noted the Second Circuit, "made more feasible by maximizing the scope of a discharge." *United States v. LTV Corp. (In re Chateaugay),* 944 F.2d 997, 1002 (2d Cir.1991). On the other hand, a broad discharge may disadvantage potential claimants, such as tort claimants, whose injuries were allegedly caused by the debtor but which have not yet manifested and who therefore

had no reason to file claims in the bankruptcy. These competing considerations have not been resolved consistently by the cases decided to date.

Moreover, the determination when a claim arises has significant due process implications. If potential future tort claimants have not filed claims because they are unaware of their injuries, they might challenge the effectiveness of any purported notice of the claims bar date. Discharge of such claims without providing adequate notice raises questions under the Fourteenth Amendment. *See* *Mullane v. Cent. Hanover Bank & Trust Co*., 339 U.S. 306, 314 (1950).

The courts have generally divided into two groups on the decision as to when a claim arises for purposes of the Code, with numerous variations. One group has applied the conduct test [citing *Grady v. A.H. Robins*] and the other has applied what has been termed the pre-petition relationship test.

In contrast, the Eleventh Circuit criticized a conduct test that would enable individuals to hold a claim against a debtor by virtue of their potential future exposure to "the debtor's product," regardless of whether the claimant had any relationship or contact with the debtor. [citing *In re Piper*]. It stated that approach would define a "claim" too broadly in certain circumstances and would "stretch the scope of § 101(5)" too far. Similarly, a commentator observed that under the conduct test, "[c]laimants who did not use or have any exposure to the dangerous product until long after the bankruptcy case has concluded would nonetheless be subject to the terms of a preexisting confirmed Chapter 11 plan." "These claimants may be unidentifiable because of their lack of contact with the debtor or the product and, accordingly, may not have had the benefit of notice and an opportunity to participate in the bankruptcy case."

Some of the courts concerned that the conduct test may be too broad have adopted what has been referred to as a pre-petition relationship test. Under this test, a claim arises from a debtor's pre-petition tortious conduct where there is also some pre-petition relationship between the debtor and the claimant, such as a purchase, use, operation of, or exposure to the debtor's product. [The Court then discusses the *Lemelle* case]

The Second Circuit followed a similar approach in an environmental regulatory context. In *In re Chateaugay*, 944 F.2d at 1004-05, the court held that the EPA's post-confirmation costs of responding to a release of hazardous waste, even if not yet incurred at the time of bankruptcy, involved "claims" under § 101(5). The court reasoned that "[t]he relationship between environmental regulating agencies and those subject to regulation provides sufficient `contemplation' of contingencies to bring most ultimately maturing payment obligations based on pre-petition conduct within the definition of `claims' [under the Bankruptcy Code]."

A somewhat modified approach was taken by the Eleventh Circuit in a case involving the bankruptcy of Piper Aircraft, Inc. . . . The court of appeals agreed that the pre-petition relationship test was generally superior to either our test in *Frenville*, or the "conduct test" adopted by other courts of appeals. It also held that claimants having contact with the debtor's product post-petition, but prior to confirmation, also could be identified during the course of the bankruptcy procedure. It thus framed what it chose to denominate as the "Piper" test as follows:

> [A]n individual has a § 101(5) claim against a debtor manufacturer if (i) events occurring before confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's

> prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product.

The court stated that "[t]he debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct."

The pre-petition relationship test in *Piper* has been criticized for narrowing the definition of "claim" under 11 U.S.C. § 101(5).

In addition, various bankruptcy courts have followed a form of the conduct test when considering the existence of an asbestos-related claim.

Irrespective of the title used, there seems to be something approaching a consensus among the courts that a prerequisite for recognizing a "claim" is that the claimant's exposure to a product giving rise to the "claim" occurred pre-petition, even though the injury manifested after the reorganization. We agree and hold that **a "claim" arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury,** which underlies a "right to payment" under the Bankruptcy Code. Applied to the Van Brunts, it means that their claims arose sometime in 1977, the date Mary Van Brunt alleged that Grossman's product exposed her to asbestos.

That does not necessarily mean that the Van Brunts' claims were discharged by the Plan of Reorganization. Any application of the test to be applied cannot be divorced from fundamental principles of due process. Notice is "[a]n elementary and fundamental requirement of due process in any proceeding which is to be accorded finality...." *Mullane,* 339 U.S. at 314. Without notice of a bankruptcy claim, the claimant will not have a meaningful opportunity to protect his or her claim. Inadequate notice therefore "precludes discharge of a claim in bankruptcy." This issue has arisen starkly in the situation presented by persons with asbestos injuries that are not manifested until years or even decades after exposure.

The most innovative approach yet to the asbestos problem was adopted by the New York bankruptcy court as part of the Manville plan of reorganization. In an effort "to grapple with a social, economic and legal crisis of national importance within the statutory framework of [C]hapter 11," the bankruptcy court oversaw the "largely consensual plan" leading to the establishment of a trust out of which all asbestos health-related claims were to be paid. The trust was "designed to satisfy the claims of all victims, whenever their disease manifest[ed]," (the "Manville Trust"). Manville agreed to fund the trust in an amount that, over time, was "in excess of approximately $2.5 billion." The Manville Trust was the basis for Congress' effort to deal with the problem of asbestos claims on a national basis, which it did by enacting § 524(g) of the Bankruptcy Code as part of the Bankruptcy Reform Act of 1994. Section 524(g) authorizes courts "to enjoin entities from taking legal action for the purpose of ... collecting, recovering, or receiving payment or recovery with respect to any [asbestos-related] claim or demand" through the establishment of a trust from which asbestos-related claims and demands are paid.

It is apparent from the legislative history of § 524(g) that Congress was concerned that future claims by presently unknown claimants could cripple the debtor's reorganization. By enacting § 524(g), Congress took account of the due process implications of discharging future claims of individuals whose injuries were not manifest at the time of the bankruptcy petition.

The due process safeguards in § 524(g) are of no help to the Van Brunts as Grossman's Plan of Reorganization did not provide for a channeling injunction or trust under that provision. A court therefore must decide whether discharge of the Van Brunts' claims would comport with due process, which may invite inquiry into the adequacy of the notice of the claims bar date. The only open matter before the District Court is JELD-WEN's request for a declaration that the Van Brunts' claims had been discharged.

Whether a particular claim has been discharged by a plan of reorganization depends on factors applicable to the particular case and is best determined by the appropriate bankruptcy court or the district court. In determining whether an asbestos claim has been discharged, the court may wish to consider, inter alia, the circumstances of the initial exposure to asbestos, **whether and/or when the claimants were aware of their vulnerability to asbestos, whether the notice of the claims bar date came to their attention, whether the claimants were known or unknown creditors, whether the claimants had a colorable claim at the time of the bar date, and other circumstances specific to the parties, including whether it was reasonable or possible for the debtor to establish a trust for future claimants as provided by § 524(g).** These are not factors for consideration in the first instance by this court sitting en banc. Accordingly, we will reverse the decision of the District Court and remand this case to the District Court for further proceedings consistent with this opinion.

10.2.8. MAIDS INTERNATIONAL, INC. v. WARD, 194 B.R. 703 (Bankr. D. Mass. 1996)

Seeking to enforce a noncompetition clause in its franchise agreement, The Maids International, Inc. ("Maids") has brought this complaint to enjoin Michael E. Ward and Angela L. Ward (the "Debtors") from owning or operating a maintenance and cleaning service within a fifty mile radius of the franchised territory.

Maids contends neither the Debtors' bankruptcy filing nor rejection of their covenant not to compete affects its right to an injunction against the Debtors' competition.

I am thus faced with the question of whether Maids' right to injunctive relief is a "claim" within the meaning of the Bankruptcy Code and hence subject to being discharged.

At the hearing on Maids' motion for a temporary restraining order, I ruled its right to an injunction is a claim. I therefore dismissed the complaint and ordered Maids to file a proof of claim, reserving jurisdiction to issue the present opinion. Set forth here are my findings of fact and conclusions of law in support of the order of dismissal.

Maids has developed a system for establishing and operating a household maintenance and cleaning service.

On April 10, 1989, Maids signed a franchise agreement with a corporation owned and operated by the Debtors named Award Services, Inc. ("Award"). In addition to signing on behalf of Award, the Debtors signed the agreement personally as guarantors of Award's performance thereunder. The agreement also includes the Debtors within the meaning of the term "Franchise", thereby making them jointly responsible with Award.

Under the agreement, Maids gave Award the exclusive right to use its system and the name "Maids" in Concord, Massachusetts and in several nearby towns. In return, Award paid Maids $15,900 and obligated itself (and the Debtors) to pay Maids a royalty based on a percentage of its gross sales at rates which range from 4.5% to 7%, depending upon the amount of weekly gross sales. The agreement was for an initial term of five years.

The following provisions of the franchise agreement are of relevance to the present proceeding:

> FRANCHISEE further covenants that **for a period of two (2) years** after the termination or nonrenewal of the franchise, regardless of the cause of termination, **it shall not, either directly or indirectly,** for itself, or on behalf of or in conjunction with any other person, persons, partnership or corporation, **own, maintain, engage in, or participate in the operation of a maintenance and cleaning service system within a radius of fifty (50) miles** of the area designated hereunder or any then existing The Maids Unit Franchise.
>
> FRANCHISEE acknowledges that a violation of any covenant in this Paragraph will cause irreparable damage to FRANCHISOR, the exact amount of which may not be subject to reasonable or accurate ascertainment, and therefore, FRANCHISEE does hereby consent that in the event of such violation, **FRANCHISOR shall as a matter of right be entitled to injunctive relief** to restrain FRANCHISEE, or anyone acting for or on behalf (sic), from violating said covenants, or any of them. Such remedies, however, shall be cumulative and in addition to any other remedies to which FRANCHISOR may then be entitled.
>
> [A]ny controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be **settled by arbitration** conducted in Omaha, Nebraska in accordance with the commercial Arbitration Rules of the American Arbitration Association
>
> **In the event of any default** on the part of either party hereto, in addition to any other remedies of the aggrieved party, **the party in default shall pay to the aggrieved party all amounts due and all damages, costs and expenses**, including reasonable attorney's fees, incurred by the aggrieved party as a result of any such default.
>
> This Agreement was accepted in the **State of Nebraska** and shall be interpreted and construed under the laws thereof.
>
> **Nothing herein contained shall bar the right of either party to obtain injunction relief** against threatened conduct that will cause loss or damages under the usual equity rules, including the applicable rules for obtaining preliminary injunctions, provided an appropriate bond against damages be provided.

The franchisee agreement expired on April 9, 1994, the end of its five year term. Thereafter, the Debtors commenced operation of a cleaning service within the franchised territory. They operate the business under the name "Mops" and do not hold themselves out as operating a franchise of Maids.

Maids responded to this competition with a series of legal actions. It first commenced an arbitration proceeding in Omaha with the American Arbitration Association. This was uncontested by the Debtors. On March 31, 1995, the arbitrator awarded Maids damages (including interest) of $29,232. He also ordered the Debtors to cease and desist the ownership or operation of a maintenance and cleaning service until April 9, 1996, within a radius of fifty miles from the franchised area or within a radius of fifty miles from any Maids franchise existing on April 9, 1994. Maids then brought suit in the District Court of Douglas County, Nebraska. On July 20, 1995, that court entered a default judgment against the Debtors in the sum of $61,056. Apparently this was in part a confirmation of the arbitration award. At no time has any court entered an injunction against the Debtors competing, in confirmation of the arbitration award or otherwise. Maids next brought its attack closer to home. On November 1, 1995, it filed suit on the judgment in the District Court of Concord, Massachusetts. That court authorized attachments of the Debtors' residence and bank accounts.

Shortly thereafter, on November 13, 1995, the Debtors filed a petition with this court requesting entry of an order for relief under chapter 7 of the Bankruptcy Code. Undeterred, Maids on January 25, 1996 filed its complaint commencing the present adversary proceeding**. In its complaint Maids requested an injunction against the Debtors owning or operating a maintenance and cleaning establishment within a fifty mile radius of the franchised territory**. At the same time, Maids filed a motion for a temporary restraining order and asked for an emergency hearing. At the hearing on February 5, 1996, I denied the motion, dismissed the complaint and ordered Maids to file a proof of claim. Maids thereafter filed a proof of claim within the permissible filing period.

Covenants not to compete are often made by sellers of small businesses, key employees, franchisees and partners. The covenant is generally valid under state law so long as its time period, geographic area and covered activities go no further than what is reasonably necessary to protect the other's business and goodwill. For this reason, the wording of the covenant is usually restricted in time and area, and sometimes in scope of activity. The Debtors' covenant was so restricted. It is valid and enforceable.

The Debtors are clearly in breach of their covenant not to compete. Breach of the ordinary contract gives rise only to a claim for damages. Maids, however, has the additional right under state law to obtain an injunction against the Debtors' competition, without regard to the provision in the agreement permitting such relief. Although many of the decisions do not reach the issue, engaging instead in what is often a mechanical search for "executoriness," breach of a covenant not to compete presents a question which has proven difficult for the courts: Do the nondebtor's injunctive rights constitute a "claim" so as to be subject to discharge? The Debtors' discharge hinges upon this issue. A discharge in bankruptcy releases a debtor only as to liability on a "debt," which is defined as "liability on a claim." [the Court then quotes the definition of a “claim” in Section 101(5)]

Maids unquestionably has a "right to an equitable remedy" for breach of the Debtors' covenant. But does the breach also give rise to a "right to payment" within the meaning of the statute? That question is not answered by Maids having obtained a damage judgment. As shall be explained, **the damages available for breach of the covenant must be an alternative to an equitable remedy if "a right to payment" is to be present**. For all we know, the arbitration award and default judgment Maids obtained were only for damages accrued to the date of the hearings, and did not include the future damages that are an alternative to equitable relief.

The only order issued against the Debtors competing is the arbitrator's cease and desist order. No court has entered an injunction against the competition. Even if one had, it would make no difference on the claim issue. The inclusion of an equitable remedy within the definition of "claim" applies "whether or not such right to an equitable remedy is reduced to judgment. . . ."

The Supreme Court's decision in *Ohio v. Kovacs*, [469 U.S. 274 (1985),] did not involve a covenant not to compete, but it deals with the meaning of the phrase "right to payment" in the context of paragraph (B) of the claim definition. *Kovacs* has been influential in cases involving covenants not to compete. The debtor was the chief executive officer and stockholder of a corporation owning a hazardous waste site located next to a river. Prior to the bankruptcy filing, the State of Ohio had gone into state court and obtained a $75,000 judgment against the debtor and others for damage from fish kills and an injunction ordering a cleanup of the property by removal of specified wastes. When the defendants failed to comply with the cleanup order, the state court appointed a receiver, who was directed to take possession of the property and commence the cleanup. Before the receiver had completed his assignment, the debtor filed a bankruptcy petition. Ohio countered by instituting a proceeding in state court to discover the debtor's current income and assets, in preparation for making a reimbursement claim against him. The bankruptcy court stayed that proceeding. The State also filed a complaint in bankruptcy court seeking a declaration that its rights under the cleanup order were not a "claim" within the meaning of the Bankruptcy Code. The courts below ruled against it on this issue.

The Court in *Kovacs* examined the rulings of the lower courts at some length. The lower courts had stressed various considerations: the necessity that the debtor spend money to comply with his cleanup obligations, the debtor's inability to perform the cleanup, the State's possession of the site through the receiver, and the State's conduct indicating its intention to seek reimbursement from the debtor for the cleanup costs. In light of all these circumstances, the Court concluded that as a practical matter the State's claim was a monetary one falling within the definition of "claim." It stated: "[W]e cannot fault the Court of Appeals for concluding that the cleanup order had been converted into an obligation to pay money, an obligation that was dischargeable in bankruptcy."

Kovacs bears close study. The Court made no attempt to analyze the statutory definition of claim, except to note that the phrases "equitable remedy," "breach of performance" and "right to payment" are undefined. **For an equitable remedy to be a claim, the definition requires only that the breach giving rise to the equitable remedy also give rise to a "right" to payment**. It imposes no requirement that the claimant exercise his right to payment or show an intent to exercise it. Yet, without pointing to statutory language, the Court saw significance in the State's intention to seek reimbursement for cleanup costs. Nor does the statute say compliance with a court decree granting the equitable remedy must involve an expenditure of money. The Court nevertheless quotes with apparent approval from the opinion of the bankruptcy court requiring

such linkage. Indeed, the Court took pains to tie its opinion to all the various views of the lower courts. This makes the decision vague. The Court also seemed intent on confining its rationale to the particular facts before it. It apparently took this approach because of the inherent difficulty in meshing the compelling environmental concerns before it with a Bankruptcy Code which promotes a fresh start and gives no priority to prepetition environmental claims. The reasoning employed in Kovacs should therefore not be binding in cases involving covenants not to compete.

Some courts nevertheless rely upon *Kovacs* or its progeny in cases dealing with covenants. They hold that a right to injunctive relief against the debtor's competition is not a claim, and hence is not dischargeable, because compliance with the injunction involves no monetary expenditure.

There is also case law rejecting application of the *Kovacs* reasoning to these covenants. In *In re Kilpatrick*, before the bankruptcy filing a state court had enjoined the debtor from breaching his covenant not to compete. In discussing *Kovacs*, the court observed that the statutory definition of "claim" speaks only of a "right" to payment, without imposing any requirement that the claimant pursue that right or disavow the equitable remedy. **Because under state law the beneficiary of a covenant can elect to receive either damages or an injunction, the court held injunctive rights are a claim.**

Another line of cases holds the other party's right to an injunction against the debtor's competition is not a claim because only monetary rights fall within the statutory definition. These decisions contain no statutory analysis. Some seem largely motivated by facts which evoke no sympathy for the debtor.

Focusing more on the statutory definition, some courts hold the nondebtor party's injunctive right is not a claim because it is present only if the remedy at law is "inadequate", or only if the threatened harm is "irreparable," concluding from this that the nondebtor has no right to payment within the meaning of the statutory definition. Although these courts are correct in ruling a right to payment must exist under nonbankruptcy law, their holding that there is no right to payment for breach of a covenant not to compete conflicts with the damage rights of the beneficiary of a covenant as well as with the general standard employed by courts in determining whether a party's remedy at law is adequate. This requires some explanation.

An injunction against breach of the covenant is a grant of specific performance. As a result of the historical separation of courts of law and equity, such an equitable remedy is available only if the remedy at law, typically damages, is "inadequate." Courts take into account a number of factors in determining whether damages are inadequate. Principal among them are difficulty in proving the existence and amount of damages with reasonable certainty, difficulty in collecting a monetary judgment, and uncertainty that the benefits of a monetary judgment would be equivalent to the promised performance. The rule has been stated as follows: "The adequate remedy at law, which will preclude the grant of specific performance of a contract by a court of equity, must be as certain, prompt, complete, and efficient to attain the ends of justice as a decree of specific performance. Put another way, "the remedy at law, in order to exclude a concurrent remedy at equity, must be as complete, as practical and as efficient to the ends of justice and its prompt administration, as the remedy at equity."

Courts thus compare the remedies at law and equity to see which is more effective in serving the ends of justice. Difficulty in fixing damages is only one factor in that equation. In any event, **damages need only be difficult, not impossible, to prove for equitable relief to be**

available. Comparison of the two remedies usually leads to the grant of equitable relief. Doubts as to the adequacy of the remedy at law are resolved in favor of granting equitable relief. In sum, courts look quite favorably upon equitable relief. This has led one author to conclude that the adequate remedy rule is essentially dead.

Loss of future profits is typically a principal element of damages for breach of a covenant not to compete. The evidentiary problems here for Maids and other covenant beneficiaries are obvious. The proof involves futuristic projections which are especially subject to contest. Courts therefore readily grant an injunction for breach of a covenant not to compete. Indeed, the injured party invariably requests injunctive relief because an injunction gives strong assurance he will receive precisely what was bargained for. This avoids the trauma of future injury, the need to prove damages, and problems in collecting a money judgment. The request for equitable relief has historically been regarded as the election of a preferred remedy.

If the beneficiary of a covenant not to compete elects to receive damages for loss of future profits, he gets the lost profits. Lost profits are a proper element of damages for any breach of contract so long as at the time of the contract the breaching party had reason to know they would be the probable result of breach. The Debtors certainly had that knowledge. The purpose of their covenant was to protect Maids' business. Although damages must be established with reasonable certainty, an approximation rather than mathematical accuracy is all that is required. The perceived difficulty in proving lost profits is less present today because of the receptive attitude of modern courts toward proof of sophisticated financial data through expert testimony. The award of damages for lost future profits is now a commonplace remedy for breach of all kinds of contracts.

Maids therefore has the right to obtain either damages for the Debtors' future competition or an injunction against the competition. As a result, in the words of the statute, **Maids has a "right to an equitable remedy for breach of performance . . . [which] breach gives rise to a right to payment**. . . . As an alternative remedy, this right to payment permits a dollar sign to be placed on the equitable remedy, as is done with other claims. Including equitable remedies within the statute's definition of "claim" is therefore supported by a strong bankruptcy policy — equal treatment of similar rights. And because a "claim" is subject to discharge, another important bankruptcy policy is promoted — the policy favoring a debtor's fresh start, unencumbered by past commitments.

In *In re Udell*, [18 F.3d 403 (1994)], the Seventh Circuit came to the opposite conclusion, and in the process added greatly to the confusion in this troubled area of the law. The Seventh Circuit in *Udell* held Carpetland's injunctive rights were not a "claim" and hence were not dischargeable in bankruptcy. Although not finding the statutory definition of claim ambiguous, the court nevertheless looked to the [following] legislative history:

> Section 101(4)(B) [now § 101(5)(B)] represents a modification of the House-passed bill to include [sic] the definition of "claim" a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. This is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, **in some States, a judgment for specific**

> **performance may be satisfied by an alternative right to payment, in the event performance is refused; in that event the creditor entitled to specific performance would have a "claim"** for purposes of proceeding under title 11.
>
> On the other hand, rights to an equitable remedy for breach of performance with respect to which such breach does not give rise to a right to payment are not "claims" and would therefore not be susceptible to discharge in bankruptcy.[46]

The *Udell* court constructed a confusing alternative test from this floor statement. It seized on the awkward phrase "with respect to which such breach does not give rise to a right to payment" appearing in the last sentence. Because the phrase arguably modifies "equitable remedy" rather than "breach of performance," the court concluded equitable rights are a claim if payment arises from their exercise. This is opposed to the wording of the statute, which clearly requires that **the breach, not the equitable remedy, give rise to a right to payment**. And the test makes no sense because equitable remedies are typically designed to provide nonmonetary relief. Having thus created a virtually unpassable test, the court ruled it was flunked by the facts before it because the right to obtain liquidated damages arose from the contract, not from an equitable remedy under it.

The *Udell* court also fashioned another test which, if passed, would make an equitable remedy a claim. It here focused on the reference in the floor statement to a right to payment being an "alternative" to the equitable remedy. From this the court concluded all right to payment must be an alternative to the equitable remedy. Because state courts would enforce the parties' agreement by granting both damages and an injunction, the court ruled an alternative right to payment was not present, so Carpetland's rights failed this test as well. This reasoning ignores Carpetland's right to damages for future loss, which is an alternative to its equitable remedy. The floor statement's reference to a right to payment being an alternative to equitable relief is understandable because the claim for future loss is the monetary equivalent to the right to an injunction against further competition. Nor is there any reason to believe Congress intended that this alternative right to payment be the only right to payment. The statute does not say so. The injured party is obviously entitled to compensation for damages already incurred by the time of trial, as well as to an injunction against future competition. The liquidated damage clause before the court was presumably designed to provide this compensation because the parties also agreed upon an injunction to prevent future loss. *Udell* thus commits the double sin of elevating legislative history above the statute's plain wording and then misunderstanding the legislative history.

The real basis for the *Udell* court's holding emerges from the concurring opinion of Judge Raum. He thought the majority opinion "dodges this statute's plain language in an effort to reach a sensible result." To Judge Raum, and one suspects to the other panel members, discharge in bankruptcy of an injunction against competition is like a bankruptcy discharge of an injunction against trespassing, polluting, stalking or battering. Because he thought the debtor's discharge would have similar "patently absurd consequences," Judge Raum believed the plain language of the statute should not be followed.

Judge Raum's reasoning leaves much to be desired as well, quite apart from his willingness to elide what he admits to be the statute's plain wording. The case concerned breach of contract, not trespass, pollution, stalking or battery. Moreover, trespass and the like is prohibited by law,

without regard to the existence of an injunction. So a bankruptcy discharge does not terminate the obligation to refrain from such conduct. In the final analysis, the decision in *Udell* comes down to this: The court could not bring itself to equate an injunction against breach of contract with a monetary judgment for breach of contract which is routinely discharged in bankruptcy.

In summary, although the decisions are in disarray, **Maids' alternative right to damages from the Debtors' future competition in breach of their covenant not to compete is a "right to payment"** within the meaning of the statutory definition of an equitable claim. Hence, under the definition, Maids' injunctive rights constitute a claim. That state courts consider damages inadequate when compared to the equitable remedy of an injunction is beside the point. Although damages for breach of the covenant, particularly damages for lost future profits, are difficult to fix, courts are perfectly capable of doing so. This alternative right to damages fits into the statutory definition of an equitable claim very well. **The same breach, a debtor's competition and threat of further competition, "gives rise" to both a damage claim and injunctive rights**. **The definition imposes no requirement that the claimant elect to receive a monetary payment**, that compliance with the injunction require an expenditure of funds, or that the equitable remedy, as opposed to the breach, give rise to a right to payment. Following the statute's plain meaning promotes two fundamental policies of the Bankruptcy Code — the policy favoring a debtor's fresh start and the policy favoring equality among holders of similar rights.

10.3. Claim Procedures

Now that we know what a “claim” is, we have to consider how it will be dealt with in bankruptcy. Under most chapters, a creditor must file a “proof of claim,” which is an official form listing the basis for and amount of the claim sought by the creditor, and whether the creditor claims any priority or security interests. If the claim is based on a writing, the writing should be attached to the proof of claim. Bankruptcy Rule 3001(c)(1). Courts have adopted liberal rules for amending timely filed claims, so the most important thing is to get the claim form filed timely, even if the filing is imperfect.

Under Chapters 7, 12 and 13, with some exceptions, the claim must be filed within 90 days after the first date set for the meeting of creditors. Bankruptcy Rule 3002(c). One important exception is for no asset cases. The court’s notice to creditors will request that claims in apparently no-asset cases not be filed until the trustee determines that distributions will be available. At that time, the court will send out a second notice setting a deadline for filing proofs of claim. Bankruptcy Rule 3002(c)(5).

In Chapter 11 cases, creditors whose claims are listed in the schedules properly (and as undisputed, non-contingent and liquidated), need not file a proof of claim; others must file by the claims bar date set by the court (often by court rule the first date set for hearing on a disclosure statement). *See* Bankruptcy Rule 3003(c)(3).

A creditor who fails to timely file a proof of claim will not participate in distributions from the bankruptcy estate (unless the court allows a late filed claim).

Proofs of claim are deemed to be allowed as filed, unless a party in interest objects. 11 U.S.C. § 502(a). Section 502(b) provides that if an objection is filed, the claim is to be determined

(estimated by the court if unliquidated, unmatured or contingent), and allowed in the amount owing under applicable non-bankruptcy law **as of the petition date** unless one of the exceptions in Section 502(b) applies. *Id.*; 11 U.S.C. § 502(c)(1). Claims under Section 502 do not accrue post-petition interest. Section 506(b) allows over-secured claimants to recover post-petition interest and reasonable charges to the extent of their equity cushion. Otherwise, any amounts owing for unmatured interest accruing after the petition date are specifically disallowed. 11 U.S.C. § 502(b)(2). If an objection to a claim is filed, the court will determine the present discounted value of the claim as of the petition date.

Section 502 contains two important claim limitations. First, the claims of a landlord against a debtor tenant for breach (rejection) of a long term real property lease, and second the claims of an employee under a long term employment contract with an employer debtor, are limited by formulas set forth in Sections 502(b)(6) and (7). The structure of these statutory claim limitations will be examined in the following problems.

Furthermore, the statute specifically disallows entirely contingent claims for reimbursement or contribution. This prevents two creditors from recovering on the same single debt. 11 U.S.C. § 502(e)(1)(B). This too will be illustrated in the following problems.

10.4. Practice Problems: Landlord, Employer and Certain Contingent Claims

Problem 1. On January 1, Year 1, creditor lent $100,000 to the debtor. Debtor promised to repay the loan together with interest at the rate of 12% per annum, compounded monthly. Monthly compounding means that any unpaid interest each month is to be added to the principal balance to bear interest the next month. Debtor filed a Chapter 7 bankruptcy petition on April 1, Year 1, without ever making any payments on the loan. Creditor has asked you to prepare a proof of claim for filing with the bankruptcy court by July 30, Year 1, the deadline set by the bankruptcy court. In what amount should the claim be filed?

Problem 2. Charles Swindle has made a business of filing proofs of claim in numerous bankruptcy cases, even though he is owed nothing by the debtors. Is Swindle entitled to a distribution on his false claims if no one files a claim objection? 11 U.S.C. § 502(a). Is there anything stopping mountebanks like Swindle from filing baseless proofs of claim in the hope that no one will notice or have the incentive to object? (The Official Proof of Claim form reads, above the signature line, "I have examined the information in this Proof of Claim and have a reasonable belief that the information is true and correct. I declare under penalty of perjury that the foregoing is true and correct.").

Problem 3. Debtor owes $10,000 in federally insured student loans. Both debtor and student loan creditor know that this debt will not be discharged in bankruptcy. Is there any reason for the student loan lender to file a proof of claim anyway? If the student loan lender does not file a proof of claim, might the debtor want to file a proof of claim for the creditor? *See* 11 U.S.C. § 501(c).

Problem 4. Several years ago, Radio Shacke, Inc. entered into a long term 30 year lease for a store on Erie Boulevard owned by Robert Conjail. The monthly rent is $10,000. The store

was never profitable, and Radio Shacke decided to close the store. On February 1, Radio Shacke stopped paying rent. On June 1, Radio Shacke moved out of the store and sent Conjail the keys. On September 1, Radio Shacke filed a Chapter 7 bankruptcy petition. At the time of bankruptcy 25 years and 3 months remained on the lease. Conjail has been trying to re-rent the store, but the only tenant he has been able to find is willing to pay only $5,000 per month in rent for the remaining lease term. Conjail has filed a claim for all unpaid rent through the end of the lease term, and the trustee has objected to the claim. The judge has asked you to determine how much of the claim to allow. Review 11 U.S.C. § 502(b)(6) carefully and calculate the claim amount.

Problem 5. Recalculate Problem (4) assuming that the lease term expired 15 months after the bankruptcy was filed.

Problem 6. When Radio Shacke opened the store in Problem (4), it entered into a 30 year employment contract with Walter Sales to run the store. The contract required Radio Shacke to pay wages of $4,000 per month. When Radio Shacke moved out of the Store on June 1, it also stopped paying Sales under the employment contract. At the time of bankruptcy, 25 years and 3 months remained on the employment contract. Sales has filed a claim for $4,000 per month for the remaining term of the contract, and Radio Shacke has objected. The Judge has asked you to determine how much of the claim to allow. Review 11 U.S.C. § 502(b)(7) carefully and calculate the amount of Sales' claim.

Problem 7. Assume that Charles Shacke, the owner of Radio Shacke, Inc., had personally guaranteed the lease in Problem (4). When Radio Shacke stopped paying rent, Conjail demanded that Charles personally make the missed payments. Charles paid $80,000 so far, and has filed a proof of claim against Radio Shacke for the amount paid in the past plus the amount that he will owe in the future under the terms of the lease. Note that both Conjail and Charles seek to recover the future rent from Radio Shacke. The trustee has objected to Charles's claim. How much of a claim should Charles be allowed in the bankruptcy case? Review 11 U.S.C. § 502(e)(1)(B) carefully to answer this question.

10.5. Cases on Claim Estimation and Limitations

10.5.1. IN RE RADIO-KEITH-ORPHEUM CORPORATION, 106 F.2d 22 (2d Cir. 1939)

Radio-Keith-Orpheum Corporation is a holding company, organized in 1928. Some of the subsidiary companies are engaged in producing and distributing motion picture films, others in operating motion picture and vaudeville theatres. Heavy losses were encountered in 1931 and 1932, and in 1933 the company went into equity receivership. In 1934 it filed petition for reorganization as a debtor under section 77B of the Bankruptcy Act, 11 U.S.C.A. § 207. The petition was approved, and the business has since been conducted by a trustee.

The appeal of Copia Realty Corporation and Fabian Operating Corporation brings up the fairness of the treatment given to contingent claims in the plan. These appellants are landlords who leased theatres to one of the debtor's subsidiaries on the debtor's guaranties that the subsidiary would pay the rent reserved. There are no defaults under the leases, and there has never been

occasion for resort to the guaranties given by the debtor. For contingent or indeterminable claims, of which there were a number in addition to those of the appellants, the proposed plan provided in effect that in the event of a claim becoming fixed after confirmation, the claimant might assert it at such later time, any recovery to be limited to the amount that would have been allowed if default had occurred prior to confirmation and the debtor to have the right to satisfy the claim either in cash or in common stock of the same amount that the claimant would have received if he had established his claim as an unsecured claim prior to confirmation, that is to say, ten shares for each $100 of the claim.

The appellants objected to this in the district court, partly on the ground that they had no protection against later decline in value of the shares. The district judge approved of the provision in general, but sought to meet the objection of the appellants by requiring that the number of shares of common stock to be delivered in satisfaction should be determined according to the market price current at the time of default by the debtor. The plan was modified to include such a provision.

The appellants insist that even with this change the plan is prejudicial to contingent claimants in their position and unduly favorable to unsecured creditors with accrued claims and to stockholders. They ask for either a continuance of the guaranties or a security deposit in cash of at least three years' rent.

The claims based on the debtor's guaranties were wholly contingent and indeterminate in amount, there having been no default under the leases and no predictable prospect of a default. In ordinary bankruptcy [under the old Bankruptcy Act] such claims would not be provable or dischargeable to any extent. In a proceeding under section 77B, however, they are claims subject to reorganization. The section provides in paragraph (b) that "`creditors' shall include . . . all holders of claims of whatever character against the debtor or its property . . . whether or not such claims would otherwise constitute provable claims under this title." The appellants therefore were not as matter of law entitled to stand aloof and obtain a continuance of the guaranties unaffected by reorganization, the equivalent of a preference for them over unsecured creditors with accrued or determinable claims. What they were entitled to was treatment as nearly like that accorded to ordinary unsecured creditors as the circumstances permitted, and we are of opinion that the plan extends that sort of treatment to them.

The demand for a cash deposit of the maximum amount of their claims is a call for better treatment, a demand which would render it impossible in many cases to effect a reorganization. The plan as it stands is fair to these parties, and their appeal fails.

10.5.2. IN RE EL TORO MATERIALS COMPANY, INC., 504 F.3d 978 (9th Cir. 2007)

KOZINSKI, Circuit Judge:

Bankruptcy presents a unique challenge: How should a paucity of resources be allocated to cover a multiplicity of claims? Distributing money to satisfy claims is, in most cases, a zero-sum game: Every dollar given to one creditor is a dollar unavailable to satisfy the debt owed to others. For Paul to be paid in full, Peter must be short-changed. Congress sought to balance the

interests of competing creditors through an extensive set of rules organizing, prioritizing and structuring claims against the estate.

The bankruptcy estate of mining company El Toro Materials hopes to use one of these rules—a cap on damages "resulting from the termination of a lease of real property," id. § 502(b)(6)—to limit its liability for allegedly leaving one million tons of its wet clay "goo," mining equipment and other materials on Saddleback Community Church's property after rejecting its lease.

Saddleback brought an adversary proceeding against El Toro claiming $23 million in damages for the alleged cost of removing the mess, under theories of waste, nuisance, trespass and breach of contract. The bankruptcy court, on a motion for partial summary judgment, found that Saddleback's recovery would not be limited by the section 502(b)(6) cap. On certified cross-appeal the Bankruptcy Appellate Panel (BAP) reversed, holding that any damages would be capped. Saddleback appeals.

Claims made by landlords against their bankrupt tenants for lost rent have always been treated differently than other unsecured claims. Prior to 1934, landlords could not recover at all for the loss of rental income they suffered when a bankrupt tenant rejected a long-term lease agreement; future lease payments were considered contingent and thus not provable debts in bankruptcy.

The Great Depression created pressure to reform the system: A wave of bankruptcies left many landlords with broken long-term leases, buildings sitting empty and no way to recover from the estates of their former tenants. On the one hand, allowing landlords to make a claim for lost rental income would reduce the harm done to them by a tenant's breach of a long-term lease, especially in a down market when it was difficult or impossible to re-lease the premises. On the other hand, "extravagant claims for . . . unearned rent" could quickly deplete the estate, to the detriment of other creditors. The solution was a compromise in the Bankruptcy Act of 1934 allowing a claim against the bankruptcy estate for back rent to the date of abandonment, plus damages no greater than one year of future rent.

Congress dramatically overhauled bankruptcy law when it passed the Bankruptcy Reform Act of 1978. However, section 502(b)(6) of the 1978 Act was intended to carry forward existing law allowing limited damages for lost rental income. Only the method of calculating the cap was changed. Under the current Act, the cap limits damages "resulting from the termination of a lease of real property" to "the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease." 11 U.S.C. § 502(b)(6). The damages cap was "designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate."

The structure of the cap—measured as a fraction of the remaining term—suggests that damages other than those based on a loss of future rental income are not subject to the cap. It makes sense to cap damages for lost rental income based on the amount of expected rent: Landlords may have the ability to mitigate their damages by re-leasing or selling the premises, but will suffer injury in proportion to the value of their lost rent in the meantime. In contrast, collateral damages are likely to bear only a weak correlation to the amount of rent: A tenant may cause a lot of damage to a premises leased cheaply, or cause little damage to premises underlying an expensive leasehold.

One major purpose of bankruptcy law is to allow creditors to receive an aliquot share of the estate to settle their debts. Metering these collateral damages by the amount of the rent would be inconsistent with the goal of providing compensation to each creditor in proportion with what it is owed. Landlords in future cases may have significant claims for both lost rental income and for breach of other provisions of the lease. To limit their recovery for collateral damages only to a portion of their lost rent would leave landlords in a materially worse position than other creditors. In contrast, capping rent claims but allowing uncapped claims for collateral damage to the rented premises will follow congressional intent by preventing a potentially overwhelming claim for lost rent from draining the estate, while putting landlords on equal footing with other creditors for their collateral claims.

The statutory language supports this interpretation. The cap applies to damages "resulting from" the rejection of the lease. 11 U.S.C. § 502(b)(6). Saddleback's claims for waste, nuisance and trespass do not result from the rejection of the lease - they result from the pile of dirt allegedly left on the property. Rejection of the lease may or may not have triggered Saddleback's ability to sue for the alleged damages. But the harm to Saddleback's property existed whether or not the lease was rejected. A simple test reveals whether the damages result from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it? Here, Saddleback would still have the same claim it brings today had El Toro accepted the lease and committed to finish its term: The pile of dirt would still be allegedly trespassing on Saddleback's land and Saddleback still would have the same basis for its theories of nuisance, waste and breach of contract. The million-ton heap of dirt was not put there by the rejection of the lease—it was put there by the actions and inactions of El Toro in preparing to turn over the site.

Interpreting the section 502(b)(6) cap to include damage collateral to the lease would also create a perverse incentive for tenants to reject their lease in bankruptcy instead of running it out: Rejecting the lease would allow the tenant to cap its liability for any collateral damage to the premises and thus reduce its overall liability, even if staying on the property would otherwise be desirable and preserve the operating value of the business. Bankrupt tenants—especially those who have damaged the property and thus may face liability upon expiration of the lease—would pack up their wares and reject otherwise desirable leases in order to gain the benefit of capping unrelated damages. This would both reduce the operating value of the business and deny recovery to a creditor—a lose-lose situation counter to bankruptcy policy. An incentive to sacrifice efficiency in order to exploit a loophole in the liability-capping provisions would be plainly counter to congressional intent to maximize the value of the estate to creditors.

Further, extending the cap to cover any collateral damage to the premises would allow a post-petition but pre-rejection tenant to cause any amount of damage to the premises—either negligently or intentionally—without fear of liability beyond the cap. If the tenant's debt to the landlord already exceeded the cap then there would be no deterrence against even the most flagrant acts in violation of the lease, possibly even to the point of the tenant burning down the property in a fit of pique. Absent clear statutory language supporting such an absurd result, we cannot suppose that Congress intended it.

The BAP reached a contrary conclusion because it considered itself bound by its precedent in *In re McSheridan*, 184 B.R. 91 (B.A.P. 9th Cir. 1995), and therefore held that Saddleback's recovery against El Toro would be capped under section 502(b)(6). To the extent that *McSheridan*

holds section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term, it is overruled.

Saddleback's argument that section 502(b)(6) does not cap its claim for damages is properly raised before us; Saddleback did not waive the argument by failing to question the breadth of the section 502(b)(6) cap in its cross-appeal from the bankruptcy court to the BAP, as the ruling of the bankruptcy court on this issue was entirely favorable to Saddleback. Saddleback had no reason to challenge a favorable decision.

We remand for a determination on the merits of Saddleback's claim.

10.6. Priority Claims – 11 U.S.C. § 507

Congress decided to favor certain creditors over others in the bankruptcy distribution by creating priorities for favored creditors. Note that Section 507 states the order of priorities. 11 U.S.C. § 507 ("the following expenses and claims have priority **in the following order**"). Under the absolute priority rule, higher priority creditors must be paid in full before lower priority creditors receive any distribution.

We have already studied one important priority – the priority for administrative claims – primarily professionals and creditors who provide post-petition benefits to the estate. 11 U.S.C. § 507(a)(2); 503.

Prior to 2005, administrative creditors were at the top of the unsecured creditor food chain, having first priority. But in 2005, Congress subordinated administrative creditors to a new super creditor – the domestic support creditor. 11 U.S.C. § 507(a)(1). However, the administrative claims of the trustee are pushed back to the top of the heap if the trustee's administration enables the fund from which domestic support creditors are paid. 11 U.S.C. § 507(a)(1)(C).

Priorities are given to the Debtor's employees for unpaid wages (11 U.S.C. § 507(a)(4)) and certain employee benefits (11 U.S.C. § 507(a)(5)) earned within 180 days before bankruptcy up to a limit of $12,475 as of 2015 per employee.

Deposits given to the debtor for consumer goods or services are given a priority up to $2,775 as of 2015 per deposit. 11 U.S.C. § 507(a)(7).

The most complex priority is given for certain tax obligations. 11 U.S.C. § 507(a)(8). As we will see later in the course, priority taxes are also not dischargeable, so the determination of priority is particularly important for many debtors. *See* 11 U.S.C. § 523(a)(1)(A). The priority rules are different for different kinds of taxes.

The most commonly owed taxes are income taxes, and they also have the most complex priority rule. There are three separate rules – any one of which can provide a priority.

The first rule is known as the "look-back rule." If the tax return for the applicable period was first due (including any extensions) within 3 years before the bankruptcy filing, then the taxes are subject to a priority. 11 U.S.C. § 507(a)(8)(A)(i). Thus, for each tax year in which the debtor owes taxes, you must determine: (1) when the return for the tax year was due (usually April 15 of

the following year if no extension, or October 15 if an extension was granted), and (2) whether that date was within 3 years of the bankruptcy filing. Only old taxes – generally for tax years three to four years before bankruptcy – have the possibility of being non-priority.

The second rule depends on when the taxes were assessed. Assessment is the process by which the IRS records the taxes as owing on its records. The taxes shown as owing on a filed return are assessed when the return is filed. However, if the IRS claims that the debtor owes additional taxes not shown on the return, the IRS can follow a procedure to assess the additional taxes. Any taxes assessed within 240 days before bankruptcy are also entitled to a priority. 11 U.S.C. § 507(a)(8)(a)(ii). Further, that 240 day period is extended if the debtor files an offer in compromise or obtains a stay of collection during the 240 day period. 11 U.S.C. § 507(a)(8)(a)(ii)(I) and (II).

Finally, taxes that have not been assessed but are assessable after bankruptcy are entitled to priority. 11 U.S.C. § 507(a)(8)(A)(iii). Normally, the IRS has three years from the time the debtor files an income tax return to assess a deficiency. *See* 18 U.S.C. § 6501(a). Although the language is somewhat confusing, Congress intended not to provide a priority for older taxes that can be assessed post-petition only because the debtor failed to file a return, filed a late return, or committed tax fraud. 11 U.S.C. § 507(a)(8)(A)(iii) (*see* reference to Section 523(a)(1)(B) and (C)).

Withholding taxes (most sales taxes, and employee withholding taxes) are **always** given a priority, no matter how old. 11 U.S.C. § 507(a)(8)(C). Property taxes due without penalty within a year before bankruptcy are given a priority. 11 U.S.C. § 507(a)(8)(B). A three year look-back rule similar to the one for income taxes applies to non-withheld employment taxes and excise taxes. 11 U.S.C. § 507(a)(8)(D) and (E).

Tax penalties owing on priority claims and in compensation for actual pecuniary loss are given a priority. 11 U.S.C. § 507(a)(8)(G). This language is rather curious because penalties, by definition, are designed to punish not to compensate, but the section has been interpreted to apply to amounts designated as penalties but designed to compensate.

10.7. Practice Problems: Priority Claims

Problem 1. Assume that the Debtor did not obtain an extension, and that the Debtor's tax returns were due on April 15 of each year. If the Debtor files bankruptcy on February 10, 2015, which years' taxes will be entitled to priority under the look-back rule.

Problem 2. Same question as Problem (1) except the Debtor filed bankruptcy on September 21, 2015.

Problem 3. Bob Servant worked for Radio Shacke for many years. He received his last $2,000 paycheck on March 20. On the way home from work, he stopped at Wedgeman's grocery store to pick up food. Wedgeman's always cashed Servant's paychecks. Radio Shacke filed bankruptcy on March 21, and the check was dishonored by Radio Shacke's bank. Can Wedgeman's grocery store assert that the unpaid check was entitled to a wage priority under 11 U.S.C. § 507(a)(4)? *See* 11 U.S.C. § 507(d). Is Wedgeman's a subrogee or an assignee*? See In re Missionary Baptist Foundation of America*, 667 F.2d 1244 (5th Cir.1982); *In re All American Manufacturing Corp.*, 185 B.R. 79 (Bankr. S.D. Fla.1995) (subrogee has pre-existing duty to pay, assignee does not).

10.8. Subordination – 11 U.S.C. § 510

Section 510(a) of the Bankruptcy Code validates private subordination agreements. If one creditor contractually agrees to be subordinate to another, the bankruptcy court will enforce the subordination. Contractual subordination is common in sophisticated secured and unsecured financing arrangements, such as corporate bonds and debentures.

Section 510(b) provides for automatic subordination of a rescission claim by a purchaser of securities. This prevents a buyer of stock, for example, from attempting to obtain priority over other stockholders by seeking rescission of the stock purchase (which, absent this provision, would make the buyer a creditor rather than a stockholder). The provision subordinates the claim to the same priority as the security.

Section 510(c) gives the bankruptcy court the power to equitably subordinate claims. This is known as the "Deep Rock Doctrine," after one of the early equitable subordination cases, *Taylor v. Standard Gas and Electric Company*, 306 U.S. 307 (1939), where the claims of insider equity investors were subordinated to those of regular creditors. The doctrine has traditionally been used against insiders who have taken advantage of their position to benefit themselves at the expense of creditors. Courts generally use the three factors from *In re Mobile Steel Co.*, 563 F.2d 692, 699-700 (5th Cir. 1977), in deciding whether to equitably subordinate a claim or interest:

> (i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with bankruptcy law.

Because of the broad nature of the power, courts have not been entirely consistent in deciding what type of conduct qualifies for equitable subordination.

10.9. Abandonment – 11 U.S.C. § 554

Section 554 allows the trustee to abandon property that is burdensome or of inconsequential value to the estate. The Supreme Court held that the power to abandon is not without limits, however, in *Midlantic Nat'l Bank v. NJDEP*, 474 U.S. 494 (1986), reprinted below, and the courts have been trying to figure out the limits of the abandonment power ever since. If the trustee cannot abandon burdensome property, the estate must incur expenses relating to that property. The cost of cleaning up prepetition contamination essentially becomes a prepetition claim.

10.10. Cases on Abandonment of Property in Bankruptcy

10.10.1. MIDLANTIC NAT'L BANK v. NJDEP, 474 U.S. 494 (1986)

JUSTICE POWELL delivered the opinion of the Court.

These petitions for certiorari, arising out of the same bankruptcy proceeding, present the question whether § 554(a) of the Bankruptcy Code authorizes a trustee in bankruptcy to abandon property in contravention of state laws or regulations that are reasonably designed to protect the public's health or safety.

Quanta Resources Corporation (Quanta) processed waste oil at two facilities, one in Long Island City, New York, and the other in Edgewater, New Jersey. At the Edgewater facility, Quanta handled the oil pursuant to a temporary operating permit issued by the New Jersey Department of Environmental Protection (NJDEP). In June, 1981, Midlantic National Bank provided Quanta with a $600,000 loan secured by Quanta's inventory, accounts receivable, and certain equipment. The same month, NJDEP discovered that Quanta had violated a specific prohibition in its operating permit by accepting more than 400,000 gallons of oil contaminated with PCB, a highly toxic carcinogen. NJDEP ordered Quanta to cease operations at Edgewater, and the two began negotiations concerning the cleanup of the Edgewater site. But on October 6, 1981, before the conclusion of negotiations, Quanta filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. The next day, NJDEP issued an administrative order requiring Quanta to clean up the site. Quanta's financial condition remained perilous, however, and, the following month, it converted the action to a liquidation proceeding under Chapter 7. Thomas J. O'Neill was appointed trustee in bankruptcy, and subsequently oversaw abandonment of both facilities.

After Quanta filed for bankruptcy, an investigation of the Long Island City facility revealed that Quanta had accepted and stored there over 70,000 gallons of toxic, PCB-contaminated oil in deteriorating and leaking containers. Since the mortgages on that facility's real property exceeded the property's value, the estimated cost of disposing of the waste oil plainly rendered the property a net burden to the estate. After trying without success to sell the Long Island City property for the benefit of Quanta's creditors, the trustee notified the creditors and the Bankruptcy Court for the District of New Jersey that he intended to abandon the property pursuant to § 554(a). No party to the bankruptcy proceeding disputed the trustee's allegation that the site was "burdensome" and of "inconsequential value to the estate" within the meaning of § 554.

The City and the State of New York (collectively, New York) nevertheless objected, contending that abandonment would threaten the public's health and safety, and would violate state and federal environmental law. New York rested its objection on "public policy" considerations reflected in applicable local laws, and on the requirement of 28 U.S.C. § 959(b) that a trustee "manage and operate" the property of the estate "according to the requirements of the valid laws of the State in which such property is situated." New York asked the Bankruptcy Court to order that the assets of the estate be used to bring the facility into compliance with applicable law. [The bankruptcy court approved abandonment

Upon abandonment, the trustee removed the 24-hour guard service and shut down the fire-suppression system. It became necessary for New York to decontaminate the facility, with the exception of the polluted subsoil, at a cost of about $2.5 million.

On April 23, 1983, shortly after the District Court had approved abandonment of the New York site, the trustee gave notice of his intention to abandon the personal property at the Edgewater site, consisting principally of the contaminated oil. The Bankruptcy Court approved the abandonment on May 20, over NJDEP's objection that the estate had sufficient funds to protect the public from the dangers posed by the hazardous waste.

A divided panel of the Court of Appeals for the Third Circuit reversed. Although the court found little guidance in the legislative history of § 554, it concluded that Congress had intended to codify the judge-made abandonment practice developed under the previous Bankruptcy Act. Under that law, where state law or general equitable principles protected certain public interests, those interests were not overridden by the judge-made abandonment power. The court also found evidence in other provisions of the Bankruptcy Code that Congress did not intend to preempt all state regulation, but only that grounded on policies outweighed by the relevant federal interests. Accordingly, the Court of Appeals held that the Bankruptcy Court erred in permitting abandonment, and remanded both cases for further proceedings.

We granted certiorari and consolidated these cases to determine whether the Court of Appeals properly construed § 554, 469 U.S. 1207 (1985). We now affirm.

Before the 1978 revisions of the Bankruptcy Code, the trustee's abandonment power had been limited by a judicially developed doctrine intended to protect legitimate state or federal interests. [Court reviews historical cases]. Thus, when Congress enacted § 554, there were well-recognized restrictions on a trustee's abandonment power. In codifying the judicially developed rule of abandonment, Congress also presumably included the established corollary that a trustee could not exercise his abandonment power in violation of certain state and federal laws. The normal rule of statutory construction is that, if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.

Neither the Court nor Congress has granted a trustee in bankruptcy powers that would lend support to a right to abandon property in contravention of state or local laws designed to protect public health or safety. As we held last Term when the State of Ohio sought compensation for cleaning the toxic waste site of a bankrupt corporation:

> "Finally, we do not question that anyone in possession of the site -- whether it is [the debtor] or another in the event the receivership is liquidated and the trustee abandons the property, or a vendee from the receiver or the bankruptcy trustee -- must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions."

Ohio v. Kovacs, 469 U.S. 274, 285 (1985) (emphasis added).

Congress has repeatedly expressed its legislative determination that the trustee is not to have carte blanche to ignore nonbankruptcy law. Where the Bankruptcy Code has conferred special powers upon the trustee and where there was no common law limitation on that power, Congress has expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety. For example, § 362(b)(5) permits the Government to enforce "nonmonetary" judgments against a debtor's estate.

It is clear from the legislative history that one of the purposes of this exception is to protect public health and safety:

Petitioners have suggested that the existence of an express exception to the automatic stay undermines the inference of a similar exception to the abandonment power: had Congress sought to restrict similarly the scope of § 554, it would have enacted similar limiting provisions. This argument, however, fails to acknowledge the differences between the predecessors of §§ 554 and 362. As we have noted, the exceptions to the judicially created abandonment power were firmly established. But in enacting § 362 in 1978, Congress significantly broadened the scope of the automatic stay, an expansion that had begun only five years earlier with the adoption of the Bankruptcy Rules in 1973. Between 1973 and 1978, some courts had stretched the expanded automatic stay to foreclose States' efforts to enforce their antipollution laws, and Congress wanted to overrule these interpretations in its 1978 revision.

28 U.S.C. § 959(b) provides additional evidence that Congress did not intend for the Bankruptcy Code to preempt all state laws. Section 959(b) commands the trustee to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State." Petitioners have contended that § 959(b) is relevant only when the trustee is actually operating the business of the debtor, and not when he is liquidating it. Even though § 959(b) does not directly apply to an abandonment under § 554(a) of the Bankruptcy Code -- and therefore does not delimit the precise conditions on an abandonment -- the section nevertheless supports our conclusion that Congress did not intend for the Bankruptcy Code to preempt all state laws that otherwise constrain the exercise of a trustee's powers.

Although the reasons elaborated above suffice for us to conclude that Congress did not intend for the abandonment power to abrogate certain state and local laws, we find additional support for restricting that power in repeated congressional emphasis on its "goal of protecting the environment against toxic pollution." [The Court discusses various environmental laws. The Court noted that CERCLA] “also empowers the Federal Government to secure such relief as may be necessary to avert ‘imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release of a hazardous substance.’” 42 U.S.C. § 9606. In the face of Congress' undisputed concern over the risks of the improper storage and disposal of hazardous and toxic substances, we are unwilling to presume that, by enactment of § 554(a), Congress implicitly overturned longstanding restrictions on the common law abandonment power.

[W]e conclude that Congress did not intend for § 554(a) to preempt all state and local laws. The Bankruptcy Court does not have the power to authorize an abandonment without formulating conditions that will adequately protect the public's health and safety. Accordingly, without reaching the question whether certain state laws imposing conditions on abandonment may be so onerous as to interfere with the bankruptcy adjudication itself, **we hold that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards**.[9]

[9] This exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from **imminent and identifiable harm**.

[Editor's Note: Three judges dissented, pointing out that their disagreement was somewhat mitigated by the conclusion that only certain "identified hazards" that posted an "imminent and identifiable harm" limited the trustee's abandonment power. Most of the cases decided after *Midlantic* have tried to address which "identified hazards" limit the abandonment power and which do not.]

10.11. Estimation of Claims

Bankruptcy Code Section 502(c) allows the court to estimate the dollar value of claims that are contingent (liability is uncertain), unliquidated (amount of the claim is uncertain), or that is based on a breach giving rise to an equitable remedy (which similarly would normally be unliquidated), if estimation is necessary under the circumstances because the claim cannot be determined timely (determining the claim would "unduly delay the administration of the estate").

10.11.1. BITTNER v. BORNE CHEMICAL COMPANY, INC., 691 F.2d 134 (3d Cir. 1982)

Prior to filing its voluntary petition under Chapter 11 of the Code, Borne commenced a state court action against Rolfite for the alleged pirating of trade secrets and proprietary information from Borne. The Rolfite Company filed a counterclaim, alleging, *inter alia*, that Borne had tortiously interfered with a proposed merger between Rolfite and the Quaker Chemical Corporation (Quaker) by unilaterally terminating a contract to manufacture Rolfite products and by bringing its suit. Sometime after Borne filed its Chapter 11 petition, the Rolfite stockholders sought relief from the automatic stay so that the state court proceedings might be continued. Borne then filed a motion to disallow temporarily the Rolfite claims until they were finally liquidated in the state court. The bankruptcy court lifted the automatic stay but also granted Borne's motion to disallow temporarily the claims, extending the time within which such claims could be filed and allowed if they should be eventually liquidated.

Upon denial of their motion to stay the hearing on confirmation of Borne's reorganization plan, the Rolfite stockholders appealed to the district court, which vacated the temporary disallowance order and directed the bankruptcy court to hold an estimation hearing. The parties agreed to establish guidelines for the submission of evidence at the hearing, and, in accordance with this agreement, the bankruptcy court relied on the parties' choice of relevant pleadings and other documents related to the state court litigation, and on briefs and oral argument. After weighing the evidence, the court assigned a zero value to the Rolfite claims and reinstated its earlier order to disallow temporarily the claims until such time as they might be liquidated in the state court, in effect requiring a waiver of discharge of the Rolfite claims from Borne. Upon appeal, the district court affirmed.

The Code, the Rules of Bankruptcy Procedure, 11 U.S.C. app. (1977), and the Suggested Interim Bankruptcy Rules, 11 U.S.C.A. (1982), are silent as to the manner in which contingent or unliquidated claims are to be estimated. Despite the lack of express direction on the matter, we are persuaded that Congress intended the procedure to be undertaken initially by the bankruptcy

judges, using whatever method is best suited to the particular contingencies at issue. The principal consideration must be an accommodation to the underlying purposes of the Code. It is conceivable that in rare and unusual cases arbitration or even a jury trial on all or some of the issues may be necessary to obtain a reasonably accurate evaluation of the claims. Such methods, however, usually will run counter to the efficient administration of the bankrupt's estate and where there is sufficient evidence on which to base a reasonable estimate of the claim, the bankruptcy judge should determine the value. In so doing, the court is bound by the legal rules which may govern the ultimate value of the claim. For example, when the claim is based on an alleged breach of contract, the court must estimate its worth in accordance with accepted contract law. However, there are no other limitations on the court's authority to evaluate the claim save those general principles which should inform all decisions made pursuant to the Code.

In reviewing the method by which a bankruptcy court has ascertained the value of a claim under section 502(c)(1), an appellate court may only reverse if the bankruptcy court has abused its discretion. That standard of review is narrow. The appellate court must defer to the congressional intent to accord wide latitude to the decisions of the tribunal in question. Section 502(c)(1) of the Code embodies Congress' determination that the bankruptcy courts are better equipped to evaluate the evidence supporting a particular claim within the context of a particular bankruptcy proceeding. Thus, an appellate court can impose its own judgment only when "the factors considered [by the bankruptcy court] do not accord with those required by the policy underlying the substantive right or if the weight given to those factors is not consistent with that necessary to effectuate that policy...."

According to the Rolfite stockholders, the estimate which section 502(c)(1) requires is the present value of the probability that appellants will be successful in their state court action. Thus, if the bankruptcy court should determine as of this date that the Rolfite stockholders' case is not supported by a preponderance or 51% of the evidence but merely by 40%, they apparently would be entitled to have 40% of their claims allowed during the reorganization proceedings, subject to modification if and when the claims are liquidated in state court. The Rolfite stockholders contend that instead of estimating their claims in this manner, the bankruptcy court assessed the ultimate merits and, believing that they could not establish their case by a preponderance of the evidence, valued the claims at zero.

We note first that the bankruptcy court did not explicitly draw the distinction that the Rolfite stockholders make. Assuming however that the bankruptcy court did estimate their claims according to their ultimate merits rather than the present value of the probability that they would succeed in their state court action, we cannot find that such a valuation method is an abuse of the discretion conferred by section 502(c)(1).

The validity of this estimation must be determined in light of the policy underlying reorganization proceedings. In Chapter 11 of the Code, Congress addressed the complex issues which are raised when a corporation faces mounting financial problems.

The modern corporation is a complex and multi-faceted entity. Most corporations do not have a significant market share of the lines of business in which they compete. The success, and even the survival, of a corporation in contemporary markets depends on three elements: First, the ability to attract and hold skilled management; second, the ability to obtain credit; and third, the corporation's ability to project to the public an image of vitality....

> One cannot overemphasize the advantages of speed and simplicity to both creditors and debtors. Chapter XI allows a debtor to negotiate a plan outside of court and, having reached a settlement with a majority in number and amount of each class of creditors, permits the debtor to bind all unsecured creditors to the terms of the arrangement. From the perspective of creditors, early confirmation of a plan of arrangement: first, generally reduces administrative expenses which have priority over the claims of unsecured creditors; second, permits creditors to receive prompt distributions on their claims with respect to which interest does not accrue after the filing date; and third, increases the ultimate recovery on creditor claims by minimizing the adverse effect on the business which often accompanies efforts to operate an enterprise under the protection of the Bankruptcy Act.

124 Cong.Rec. H 11101-H 11102 (daily ed. Sept. 28, 1978). Thus, in order to realize the goals of Chapter 11, a reorganization must be accomplished quickly and efficiently.

If the bankruptcy court estimated the value of the Rolfite stockholders' claims according to the ultimate merits of their state court action, such a valuation method is not inconsistent with the principles which imbue Chapter 11. Those claims are contingent and unliquidated. According to the bankruptcy court's findings of fact, the Rolfite stockholders' chances of ultimately succeeding in the state court action are uncertain at best. Yet, if the court had valued the Rolfite stockholders' claims according to the present probability of success, the Rolfite stockholders might well have acquired a significant, if not controlling, voice in the reorganization proceedings. The interests of those creditors with liquidated claims would have been subject to the Rolfite interests, despite the fact that the state court might ultimately decide against those interests after the reorganization. The bankruptcy court may well have decided that such a situation would at best unduly complicate the reorganization proceedings and at worst undermine Borne's attempts to rehabilitate its business and preserve its assets for the benefit of its creditors and employees. By valuing the ultimate merits of the Rolfite stockholders' claims at zero, and temporarily disallowing them until the final resolution of the state action, the bankruptcy court avoided the possibility of a protracted and inequitable reorganization proceeding while ensuring that Borne will be responsible to pay a dividend on the claims in the event that the state court decides in the Rolfite stockholders' favor. Such a solution is consistent with the Chapter 11 concerns of speed and simplicity but does not deprive the Rolfite stockholders of the right to recover on their contingent claims against Borne.

The court's ultimate finding of fact — that the Rolfite stockholders' claims in the reorganization proceeding were worth zero — must also be upheld since it too is not clearly erroneous. The subsidiary findings of the court plainly indicated that the Rolfite counterclaim in the state action lacked legal merit. Faced with only the remote possibility that the state court would find otherwise, the bankruptcy court correctly valued the claims at zero. On the basis of the court's subsidiary findings, such an estimation was consistent both with the claims' present value and with the court's assessment of the ultimate merits.

10.12. Distribution to Creditors – 11 U.S.C. § 726

After the trustee sells off all of the debtor's non-exempt assets and recovers avoided transfers, and after all claims are filed, allowed or disputed and determined, all that's left is distributing the money to creditors in accordance with the absolute priority rule. Section 726 of the Bankruptcy Code provides for that distribution. First, priority claims are paid in the order specified in Section 507. 11 U.S.C. § 726(a)(1). Then timely filed and late filed unsecured claims are paid. 11 U.S.C. §§ 726(a)(2); (a)(3). Fines, penalties and forfeitures not in compensation for actual pecuniary loss are paid after general unsecured creditors. 11 U.S.C. § 726(a)(4).

If there is money left over after all unsecured claims are paid in full, then all unsecured creditors are entitled to post-petition interest on their claims (from the petition date until the date of payment) at the legal rate. 11 U.S.C. § 726(a)(5). Only after all creditors are paid in full with interest is any distribution made to the debtor. 11 U.S.C. § 507(a)(6).

If the trustee does not have enough money to pay all of the claims in any class in full, the claims in that last class share *pro rata*, and no one junior receives any distribution. *See* 11 U.S.C. § 726(b).

A recent circuit split has developed over the meaning of the "legal rate" of interest that must be paid by a solvent estate. In *In re Cardelucci*, 285 F.3d 1231, 1234 (9th Cir. 2002), the court held that "legal rate" means the federal judgment rate of interest, which at the time of this writing is a very low 0.63%. More recently, in *In re Dvorkin Holdings, LLC*, 2016 BL 96242 (N.D. Ill. 2016), the district court rejected *Cardelucci*, holding that the solvent debtor must pay the parties' prepetition contract rate.

The next section deals with what happens to the claims of creditors who are not paid in full from the bankruptcy estate.

Chapter 11. The Discharge

11.1. The Discharge Order

The primary benefit of Chapter 7 bankruptcy to most individual debtors is the discharge. The discharge gives the debtor a fresh start free from the obligation to pay his or her prepetition debts. Unless the debtor is denied a discharge or the debt is not discharged, the claims that remain unpaid after the Chapter 7 distribution from the bankruptcy estate are discharged.

Section 524 of the Bankruptcy Code takes over after discharge where the automatic stay left off during the bankruptcy case. The automatic stay terminates upon the grant of a discharge. 11 U.S.C. § 362(c)(2)(C). Section 524 imposes an injunction against filing or continuing a suit to collect a discharged debt, or taking any other act to collect a discharged debt from the debtor or from the debtor's property on account of the debtor's **personal liability** for the debt. Note that Section 524 does not enjoin actions to foreclose prepetition liens that pass through bankruptcy – only the debtor's "personal liability" for the debt is discharged. Only the debtor who filed the bankruptcy is discharged. Third parties (such as co-debtors and guarantors) who are jointly, severally or partially liable for the debt with the debtor remain liable. 11 U.S.C. § 524(e).

Violation of the post-discharge injunction is prosecuted in the same way as violations of the automatic stay. A creditor who violates the post discharge injunction is in contempt of court. In a state court lawsuit, the debtor must raise the discharge as an affirmative defense under state law or it is deemed waived. Alternatively, Debtors can reopen their bankruptcy cases (if they have been closed) and seek to hold the creditor in contempt of court for violating the post-discharge injunction.

11.2. Cases on Violation of the Discharge Order

11.2.1. IN RE ANDRUS, 189 B.R. 413 (N.D. Ill. 1995)

Stanley Stann appeals an order of the bankruptcy court finding him in civil contempt and directing him to pay remedial and compensatory damages. We affirm the decision of the bankruptcy court.

The debtors obtained an Order of Discharge on June 24, 1993. In February or March of 1995 Stann decided to post a large sign near the debtors house reading, "GENE ANDRUS, WHERE'S MY MONEY?" The debtors immediately filed a motion for contempt before the bankruptcy court, and Stann agreed to take down the sign. The parties subsequently entered an agreed Order for Injunctive Relief and Dismissal of Proceedings, which specifically enjoined "the commencement or continuation of any action, the employment of any process, or an act, to collect, recover or offset" the discharged debt. The order also specifically referred to the injunction imposed by 11 U.S.C. § 524 against attempts to collect a discharged debt.

Stann apparently was not deterred by this order or the statutory injunction. Soon after resolving the dispute over the first sign, Stann posted a second sign on his property — which is

two doors down from the debtors' house — declaring, "GENE ANDRUS WENT BANKRUPT! HE DIDN'T PAY HIS BILLS. HE IS A DEADBEAT! THIS IS A PUBLIC SERVICE ANNOUNCEMENT." The signs were not the only evidence of Stann's disappointment with the debtors; indeed, the bankruptcy court found them to be merely part of a larger pattern of misconduct intended to pressure the debtors into paying the discharged debt. On February 9, 1995, Stann left a harassing and vulgar message on the Andrus's answering machine, in which Stann threatened to ruin Eugene Andrus's reputation in the community unless he repaid the debt.[4]

On June 8, 1995, Stann approached the debtors in their car and repeatedly asked them to repay the money they owed him.[5] On July 3, 1995, Stann shouted to Ms. Andrus from his yard:

> Who do you think you are? Your husband is a deadbeat. I've told the whole Ukrainian community about you. You're just off the boat. You think that that attorney of yours is going to protect you? Your attorney knows nothing. Get yourself a better attorney. No court is going to protect you. You get that deadbeat husband of yours. I want my money. I want Gene. I want my money.

The following day Stann approached the Andruses and offered to fight Gene Andrus for the money:

> You're a deadbeat. I want my money. Let's go. I'll beat it out of you. Let's go fight over it. I'm going to beat the shit out of you. And if you win, Gene — because you're such a faggot you're not going to win — but if you win, I'll drop the $20,000.

The Andruses brought a civil contempt action against Stann pursuant to Fed. R.Bankr.P. 9020, alleging that he violated the injunction in the Discharge Order, as well as 11 U.S.C. § 524(a)(2). After an evidentiary hearing, during which Stann corroborated most of the testimony offered by Ms. Andrus, Judge Schmetterer found that Stann had willfully violated the injunction imposed by § 524(a)(2) by engaging a course of conduct intended to force the payment of a discharged debt. The bankruptcy court also found that the signs posted by Stann did not constitute protected speech under the First Amendment, and thus could provide the basis for a finding of contempt. The court ordered Stann to pay remedial and compensatory damages, and directed him to remove the sign posted on his property, although it did not prohibit Stann from engaging in protected speech in the future.

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[4] "Stan Stann here (parts inaudible) to return my call so now we're going to have to get real embarrassing. Once I start the ball rolling on these things, Gene, I ain't going to f____g talk to you anymore. I would appreciate the courtesy of ... a call back, otherwise we're going to start making your life real interesting. And, hey, you're bringing this all on yourself, but we're going to let the whole world know what a cheap son of a bitch you are. So I suggest that you get in touch with me; otherwise, once I start the moving this time on it, banners and the whole thing, the whole shot, you're going to be ashamed to even come home because everyone on this lake is going to know what a f____g deadbeat you are. So you'd better make peace with me fairly quickly, guy."

[5] Ms. Andrus testified that Stann said: "I want my f___ing money, I want my money. Why do you f___ with me? ... I'm going to get my money. Your faggot husband. No one is going to protect you. Wait until you throw another party. You think you're going to have another party in your house? You just wait and see."

Stann raises a single issue in this appeal: Did the bankruptcy court's interpretation of § 524(a)(2) and its finding of contempt "abridg[e] the freedom of speech" guaranteed by the First Amendment to the United States Constitution? Although wary of injunctions restricting speech, and mindful of the importance of the First Amendment in civic life, we nonetheless conclude that the contempt order issued in this case did not run afoul of the First Amendment.

At the outset we observe that the injunction and contempt order were directed at conduct — that is, attempting to collect a discharged debt. The fact that Stann's conduct contained a "communicative element" does not necessarily render it protected speech under the First Amendment. . . . Proper enforcement of the Bankruptcy Code would be seriously undermined if courts could not enjoin efforts at collecting discharged debts and punish those who ignored court orders.

However, even assuming arguendo that the injunction and contempt order issued by the bankruptcy court were directed at pure speech, we still do not find them violative of the First Amendment. When evaluating a content-neutral injunction — such as the one embodied in § 524 and the Discharge Order[7] — we ask "whether the challenged provisions of the injunction burden no more than necessary to serve a significant government interest." We discern two significant governmental interests implicated by Stann's conduct: the power of the courts to enforce and protect their judicial process, and the ability of the Bankruptcy Code to protect debtors. The former has long been recognized as significant component in the effective administration of justice, and can justify the fashioning of effective remedies that incidentally implicate speech.

In sum, we believe that the contempt order and injunction satisfied the requirements of O'Brien and were therefore constitutional. Alternatively, even if these restrictions implicated pure speech, we find that they did not burden more speech than necessary to serve the significant government interests at risk. Accordingly, we affirm the contempt order of the bankruptcy court. It is so ordered.

11.3. Denial of Discharge

There are 5 ways in which the debtor can be denied a discharge entirely.

Bad Acts. First, as we have already seen in connection with debtors who convert excessive amounts of non-exempt to exempt property, the debtor can be denied a discharge for bad prepetition or post-petition conduct. 11 U.S.C. §§ 727(a)(2) – (a)(7). These rules apply to actual intent fraudulent transfers before or after bankruptcy, destroying or falsifying records, making a false oath, failing to explain satisfactorily the loss of assets, and failing to obey court orders. Courts have substantial discretion when bad acts are shown to determine whether the acts justify denial of discharge, and generally impose a high standard of proof for denial. Creditors seeking denial of discharge must file a complaint for denial of discharge within 60 days after the first meeting of creditors. Bankruptcy Rule 4004(a).

Non-Individuals. Second, only individuals – non-entities – are entitled to a Chapter 7 discharge. 11 U.S.C. § 707(a)(1). This is because entities are non-functioning shells after bankruptcy (all assets have been liquidated and business operations have been terminated). There is no need for a non-functioning shell to receive a discharge because it is, for all intents and

purposes, dead. The proprietors of the non-functioning shell should follow the dictates of state law to terminate the entity. An individual has a life after bankruptcy, and freed from the burden of excessive debt can begin life with a financial fresh start due to the discharge. Entities do receive a discharge of debts under the reorganization provisions of Chapters 9, 11 and 12. *See* 11 U.S.C. §§ 944(b), 1141(d), 1228(a).

Prior Bankruptcy Cases. Third, a discharge is denied for debtors who obtained a discharge in a prior bankruptcy case filed within certain prescribed time periods before the current case. The rule compares the filing date of the previous case to the filing date of the new case, and requires **8 years** between a previous Chapter 7 or 11 case and a new Chapter 7 case, **six years** between a previous Chapter 12 or 13 case and a new Chapter 7 case. 11 U.S.C. §§ 727(a)(8), (a)(9). In order for the restriction on filing a new case to apply, the debtor must have received a discharge in the prior case. *Id*. The date that the prior discharge was granted does not matter.

Prior Case Dismissals within 180 Days for "Bad Acts". Individual debtors may not be eligible to obtain a discharge in a new case if the previous bankruptcy case was dismissed for certain enumerated reasons within 180 days before the filing of the new case. This rule only applies if the prior case was dismissed because:

> (1) the debtor "willfully failed to abide by orders of the court,"
>
> (2) the debtor failed "to appear before the court in proper prosecution of the case," or
>
> (3) "where the debtor requested and obtained voluntary dismissal . . . following the filing of a request for relief from the automatic stay."

11 U.S.C. § 109(g). The third ground in Section 109(g) is troubling, because it is terribly overbroad. The provision was intended to prevent debtors from gaming the system by dismissing one case in response to a relief from stay motion that the debtor knew would be granted, and then refiling a new case to further stall the creditor. Unfortunately, the rule is so broad that it punishes debtors who were not abusing the system. For example, the debtor may have voluntarily dismissed the case after the relief from stay motion was **denied**. Or the debtor may have dismissed the case after the creditor obtained relief from stay, and did not file the new case until the creditor completed a foreclosure. A number of courts have interpreted the provision narrowly to prevent unfairness where the dismissal had nothing to do with the request for relief from stay. *See* *In re Luna*, 122 B.R. 575 (B.A.P. 9th Cir. Cal. 1991) (denying dismissal when result would be illogical, unintended and unjust); *In re Santana*, 110 B.R. 819 (Bankr. W.D. Mich. 1990) (same). Some courts have read the word "following" to mean that the request for dismissal must be prompted by the relief from stay motion, *In re Duncan*, 182 B.R. 156 (Bankr. W.D. Va. 1995), and most courts require that a proper motion for relief from stay be pending at the time the debtor requests and obtains the voluntary dismissal. *See* *In re Jones*, 99 B.R. 412 (Bankr. E.D. Ark. 1989); *In re Milton*, 82 B.R. 637 (Bankr. S.D. Ga. 1988).

Bad Act Revocations. Finally, a discharge may also be revoked, generally within one year after it is granted, for bad acts discovered after discharge. 11 U.S.C. § 727(d) and (e).

11.4. Cases on Denial of Discharge

11.4.1. DAVIS v. DAVIS, 911 F.2d 560 (11th Cir. 1990)

In 1983, the Appellee, Roe Davis, and the Debtor/Appellant, Don Davis, opened a pharmacy business. Roe Davis owned fifty-one percent of the stock, while Don Davis owned the remaining forty-nine percent. Both Roe and Don Davis, who are unrelated, individually signed promissory notes for the money they borrowed to operate the business. The business failed and was closed in October 1985. The final bank loan used to finance the pharmacy was payable in October 1986. Two days after the due date, the Debtor discussed with his attorney his inability to pay this note and his concern about possibly losing his home. At the suggestion of his attorney, the Debtor deeded his one-half interest in his home to his wife. Shortly thereafter, in November 1986, Appellee Roe Davis paid off the outstanding balance on the bank note, amounting to $118,395.24.

Appellee Roe Davis sued the Debtor for contribution and obtained a default judgment for $58,694.24. Two days after obtaining this judgment, the Appellee filed a fraudulent conveyance action against the Debtor seeking to set aside the transfer of the Debtor's interest in his home to his wife. Upon service of this complaint, the Debtor consulted his attorney, who advised him to see a bankruptcy lawyer. The Debtor did so, and was advised to reverse the transfer of his home to his wife. The necessary deed was prepared, executed and recorded. The day following recordation, the Debtor filed for bankruptcy protection under Chapter 7 of the Bankruptcy Code.

In his bankruptcy schedules, the Debtor/Appellant disclosed the existence of these transfers, which had taken place within one year of the bankruptcy filing. In April 1987, the Appellee filed an adversary proceeding seeking to deny the Debtor discharge under section 727(a)(2)(A) of the Code.

The matter was tried in December 1987. The bankruptcy court found that the transfer of property of the Debtor to his wife was made with the intent to hinder, delay or defraud a creditor as proscribed by section 727(a)(2)(A), notwithstanding retransfer of the property completed the day before the petition was filed.

The Debtor contended that discharge should not be denied under section 727(a)(2)(A), since the transfer in question did not in fact diminish the assets available to creditors. In a subsequent memorandum opinion, the bankruptcy court rejected this argument, and denied the Debtor a discharge.

In his appeal to this court, the Debtor identifies two issues. First, the Debtor argues the district court erred in affirming the denial of discharge in light of the fact that the Debtor's transfer of property to his wife did not in fact reduce the assets available to creditors. We disagree in light of Future Time [where the court] reasoned:

> When appellant transferred his interest in the residence to his wife, he obviously intended to shield what he thought was valuable property from the claims of his creditors. To hold now that there occurred no transfer of property with the intent to hinder creditors merely because the debts on the residence exceeded its estimated

> fair market value would be to reward appellant for his wrongdoing, which the court refuses to do.

The Debtor next argues the district court erred in affirming the denial of the Debtor discharge under section 727(a)(2)(A) since the property fraudulently conveyed to his wife was recovered prior to his filing bankruptcy. The Debtor relies principally on *In re Adeeb*, 787 F.2d 1339 (9th Cir. 1986), for the proposition that, as used in section 727(a)(2)(A), the word "transferred" should be read to mean "transferred and remained transferred" at the time a debtor files his bankruptcy petition. Despite the clear, unambiguous language used in the statute, the *Adeeb* court reasoned that its reading of "transferred" was "most consistent with the legislative purpose of the section." The court wrote that such a reading would "encourage honest debtors to recover property they have transferred during the year preceding bankruptcy" and serve to facilitate "the equitable distribution of assets among creditors by ensuring that the trustee has possession of all of the debtor's assets." The court added that this readily allowed the "honest debtor to undo his mistakes and receive his discharge." Finally, the court noted its reliance on the practical aspects of such a situation:

> It is not uncommon for an uncounseled or poorly counseled debtor faced with mounting debts and pressure from his creditors to attempt to protect his property by transferring it to others. Upon later reflection or upon obtaining advice from experienced bankruptcy counsel, the debtor may realize that his original transfer of the property was a mistake. If the debtor is informed that his mistake bars him from a discharge in bankruptcy, he will have no incentive to attempt to recover the property or to reveal its existence to his creditors. Rather, he will have a strong incentive to continue to hide his assets.

Normally, a court should interpret a statute in a manner consistent with the plain meaning of the language used in the statute. The statutory language of section 727(a)(2)(A) is plain and unambiguous. Congress certainly was capable of drafting a statute which would deny a discharge only when assets were fraudulently transferred and remained transferred at the time of filing of bankruptcy proceedings, but it did not. We are a court and not a legislative body; therefore, we are not free to create by interpretation an exception in a statute which is plain on its face. We therefore reject the approach initiated by the Ninth Circuit in *Adeeb*. We recognize that our holding may work hardship in some cases, perhaps this one, but we are compelled to apply statutory law as enacted by Congress.

11.4.2. IN RE BAJGAR, 104 F.3d 495 (1st Cir. 1997)

Bajgar and his wife jointly owned a vacant parcel of land in Port St. Lucie, Florida ("the Florida property"). On November 10, 1993, Bajgar conveyed his interest in the land to his wife, purportedly as a belated engagement gift, delayed twenty-three years. In return, Bajgar received "love and affection." The conveyance was recorded on December 2, 1993. At the time of the conveyance, Bajgar faced a collection action and several foreclosures. He conceded at trial that

the transfer was fraudulent within the meaning of the Bankruptcy Code, admitting that the transfer was completed with actual intent to hinder, delay, or defraud his creditors.

On May 16, 1994, less than one year after the conveyance of the Florida property, Bajgar filed a petition for relief under Chapter 7 of the Bankruptcy Code. In his petition, Bajgar disclosed the fraudulent transfer by attaching a copy of the deed to the statement of affairs. At the mandatory creditors meeting, Bajgar and his wife volunteered to reconvey the Florida property.

On August 19, 1994, Martin, one of Bajgar's creditors, filed a complaint [alleging] a violation of 11 U.S.C. § 727(a)(2)(A). On September 30, 1994, at Bajgar's request and on the advice of counsel, Bajgar's wife reconveyed the Florida property to herself and Bajgar jointly by quitclaim deed. Bajgar's wife completed the retransfer more than four months after Bajgar filed his voluntary bankruptcy petition, more than three months after the meeting with creditors, and more than one month after Martin first objected to discharge.

The bankruptcy court (Hillman, J.) held that the conveyance of the Florida property did not constitute grounds to deny Bajgar's discharge under Section 727(a)(2)(A). The district court affirmed.

This case presents this Circuit with an issue of first impression: whether an admittedly fraudulent transfer of a debtor's property within one year before the filing of a voluntary petition for relief under Chapter 7 of the Bankruptcy Code is cured for purposes of dischargeability pursuant to Section 727(a)(2)(A) by its re-transfer to the debtor after the debtor files his petition. We hold that retransfer subsequent to filing a voluntary bankruptcy petition does not cure the fraudulent transfer, and, thus, does not avail the debtor discharge under Section 727.

The statutory language of Section 727(a)(2)(A) is sufficiently plain. The statute specifically authorizes denial of discharge if the debtor "transferred" property within one year prior to the date of filing the bankruptcy petition; it does not qualify this provision with a clause to the effect that transferred property must remain transferred. See 11 U.S.C. § 727(a)(2)(A).

Without delving into the murky realm of legislative purpose and equitable principles, the Eleventh Circuit, one of the two other courts of appeals to address this issue, reached the same conclusion we reach today. See *Davis v. Davis*, 911 F.2d 560 (11th Cir. 1990) (per curiam).

According to the Eleventh Circuit, therefore, if a debtor fraudulently transfers property within one year before the filing of a bankruptcy petition, he will not receive a discharge.

While the plain language of Section 727(a)(2)(A) and the applicable legislative history point to the conclusion that, upon proper objection, any debtor who fraudulently transfers property within one year before the filing of a bankruptcy petition is not entitled to receive a discharge pursuant to Section 727, irrespective of the timing of a reconveyance, this case presents us with a debtor who reconveyed property several months subsequent to filing a voluntary bankruptcy petition. We need not decide now either the effect of a reconveyance made prior to the filing of a voluntary bankruptcy petition or the question of a retransfer effected immediately following the filing of an involuntary petition.

Bajgar seeks solace in a Ninth Circuit case, *In re Adeeb*, 787 F.2d 1339, 1344 (9th Cir. 1986), which interpreted the term "transferred" to mean "transferred and remained transferred" in the context of Section 727(a)(2)(A). Both the bankruptcy court and the district court found *Adeeb* persuasive in this case. We do not.

[The Court reviews *Adeeb*]. Treating *Adeeb* as the subject of an involuntary petition because "[t]he involuntary petition in this case began the bankruptcy process," the court discharged *Adeeb*. The court held that "a debtor who has disclosed his previous transfers to his creditors and is making a good faith effort to recover the property transferred at the time an involuntary bankruptcy petition is filed is entitled to a discharge of his debts if he is otherwise qualified."

The *Adeeb* court, however, enunciated a different rule with respect to a debtor who files a voluntary bankruptcy petition: "[A] debtor who transfers property within one year of bankruptcy with the intent penalized by section 727(a)(2)(A) may not be denied discharge of his debts if he reveals the transfers to his creditors, **recovers substantially all of the property before he files his bankruptcy petition**, and is otherwise qualified for a discharge." As the *Adeeb* court explained, this rule demanding recovery prior to the filing of a petition "assumes the filing of a voluntary petition by the debtor. In that situation, the debtor controls the time of filing the petition. He is therefore able to time the filing to allow recovery of substantially all of his property."

Even were we to adopt *Adeeb*, its application to the instant case would result in denial of discharge. Bajgar did not recover any of the transferred property until well after he filed his voluntary bankruptcy petition. In the case of a voluntary bankruptcy petition, such as Bajgar filed, however, "[t]he Ninth Circuit requires actual reconveyance of the fraudulently transferred property before the bankruptcy filing."

We recognize that reading the term "transferred" to mean "transferred and remained transferred," could be construed, in certain instances, to advance the "purpose of the Bankruptcy Act to [distribute] the assets of the bankrupt ... among creditors and then to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes. This purpose affords the "honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

In this case, however, Bajgar did not reveal his initial fraudulent transfer until he filed his bankruptcy petition. In addition, Bajgar consulted with an experienced bankruptcy attorney at the time he executed the initial fraudulent transfer. It was not until he faced the prospect of being denied discharge pursuant to Section 727(a)(2)(A) that Bajgar actually reconveyed the property.

We are not presented with an "honest but unfortunate debtor" that the Bankruptcy Code envisions as the deserving recipient of a fresh start. Denying Bajgar discharge actually comports with the "purpose" of the Bankruptcy Act.

11.5. Exceptions to Discharge – 11 U.S.C. § 523

The Bankruptcy Code after 2005 contains 19 kinds of debts that are excepted from discharge. These debts can then be divided into automatically non-dischargeable debts that simply pass through bankruptcy unimpaired by the debtor's discharge, and debts that will be discharged unless the creditor timely files a complaint to determine that the debt is not dischargeable and ultimately obtains a non-dischargeability determination from the Bankruptcy Court. For those debts that are dischargeable unless the creditor obtains a non-dischargeability determination, the

creditor must file a non-dischargeability complaint within 60 days after the first date set for the Section 341 meeting of creditors. *See* 11 U.S.C. § 523(c); Bankruptcy Rule 4007(c).

11.6. Automatically Non-Dischargeable Debts

Taxes – 11 U.S.C. § 523(a)(1).

By far the most complex exception to non-dischargeability is for taxes owed to a governmental unit (federal, state or local). The exception starts with those taxes that are entitled to priority under Section 507(a)(8) of the Bankruptcy Code. 11 U.S.C. § 523(a)(1)(A). This part of the rule makes non-dischargeable income taxes for which a return was first due within 3 years before the bankruptcy filing (3 Year Look-back Rule), or were assessed within 240 days (plus tolling period) before bankruptcy (240 Day Assessment Rule), or were not assessed before but are assessable after bankruptcy (Post-Petition Assessability Rule). 11 U.S.C. Section 507(a)(8)(A). The rule also incorporates the complete denial of discharge for withholding taxes (§ 507(a)(8)(C)), the one year rule for property taxes (§ 507(a)(8)(B), and a 3 year look-back rule for employment and excise taxes (§ 507(a)(8)(D) and (E).

But even debtors who are able to jump over the priority hurdles do not necessarily pass the tax discharge test. Most importantly, taxes for which a **return** was due and **not filed by the date of bankruptcy** are not dischargeable under any circumstances, nor are any taxes if the debtor filed a **fraudulent return**, or willfully attempted to evade or defeat such taxes. 11 U.S.C. § 523(a)(1)(B)(i), (a)(1)(C).

This leaves taxes owing on **late filed returns**, an area of particular complexity and confusing court decisions. First, the statute boldly and clearly states that taxes owing on late returns filed more than two (2) years before bankruptcy are eligible for discharge. 11 U.S.C. § 523(a)(1)(B)(ii). Nevertheless, courts have generally denied discharge for late returns if the IRS had taken action against a non-filing debtor to collect taxes before the filing of the late return. See discussion in *In re Moroney*, 352 F.3d 902, 905-06 (4th Cir. 2003).

More recently, several courts have read flush language added in 2005 after Section 523(a)(19) to all but bar the discharge of taxes owing under a late filed return – even one filed one day late. The added language defines a "return" as one filed in compliance with non-bankruptcy law "including applicable filing requirements." One of the cases reprinted below interprets this apparently innocent definition to virtually eliminate the ability to discharge taxes owing on late filed returns, despite the main statute's clear two year rule.

Unscheduled Debts – 11 U.S.C. § 523(a)(3).

Debts of known creditors that are not scheduled by the debtor in time for the creditor to file a proof of claim or object to discharge are not discharged. However, these rules are not applied to creditors who receive actual knowledge of the bankruptcy case in time to file a claim or object to discharge. Furthermore, the majority of courts have held that the claims of omitted creditors are discharged in no asset cases, where the creditor was not harmed by the lack of notice. *See e.g. In re Anderson*, 72 B.R. 783, 787 (Bankr. D. Minn. 1987) (adopting "no harm no foul" approach); *In re Beezley*, 994 F.2d 1433 (9th Cir. 1993); *Stone v. Caplan*, 10 F.3d 285 (5th Cir. 1994); *Judd v.*

Wolfe, 78 F.3d 110 (3d Cir. 1996); *In re Madaj*, 149 F.3d 467 (6th Cir. 1998); *In re Tucker*, 143 B.R. 330 (Bankr. W.D.N.Y. 1992).

A minority of courts have held that unscheduled debts are not discharged even in no asset cases. *See In re Stark*, 717 F.2d 322 (7th Cir. 1983) (decision on whether to discharge omitted creditor based on equitable considerations); *Colonial Surety v. Weitzman*, 564 F.3d 526 (1st Cir. 2009) (holding unscheduled debts excepted to discharge even in no asset cases).

Family Law Claims – 11 U.S.C. §§ 523(a)(5), (a)(15).

Prior to 2005, the Court made a distinction between claims "in the nature of alimony, maintenance or support," and claims in the nature of a property division: the former were not dischargeable, while the latter were. Because federal law governs the determination of whether a claim agreed to as part of a separation or divorce agreement, or awarded by a court in connection with a divorce, was "in the nature of alimony, maintenance or support," the language used in the agreement or order is relevant but not determinative.

With the addition of Section 523(a)(15) in 2005, property settlements are now also non-dischargeable in Chapter 7. However, Congress did not add a cross reference to (a)(15) in the Chapter 13 discharge provisions. *See* 11 U.S.C. §§ 1328(a)(2). Therefore, the distinction between support and non-support remains relevant in Chapter 13 cases.

Government Fines and Penalties – 11 U.S.C. §§ 523(a)(7).

Fines and penalties not in compensation for actual pecuniary loss are excepted from discharge. This commonly covers things like parking tickets and traffic tickets.

Student Loans and Debts – 11 U.S.C. §§ 523(a)(8).

Student loans and debts are automatically non-dischargeable, unless the debtor obtains an "undue hardship" determination from the Court. There are two competing standards for undue hardship, both focusing primarily on the possibility (or probability) of the debtor being able to pay in the future. The major decisions are attached below. The Court of Appeals for the Seventh Circuit held in *In re Roberson*, 999 F.2d 1132 (7th Cir. 1993), that dischargeability requires a "certainty of hopelessness." More recent courts have been a bit more liberal. Still, as a general rule, healthy young debtors cannot discharge student loans or debts.

The definition of a "Student Loan" or debt is very broad. It covers both federal and state insured student loans, as well as private student loans and obligations to repay educational benefits, scholarships or stipends.

Drunk Driving – 11 U.S.C. § 523(a)(9).

A debtor who causes death or personal injury by driving a vehicle while intoxicated (alcohol or drugs beyond the legal limit) cannot discharge the debt. Property damage caused by drunk driving remains dischargeable.

Federal Criminal Restitution – 11 U.S.C. § 523(a)(13).

The Supreme Court held that criminal restitution, even though owing to private parties and partially compensatory, is flatly non-dischargeable. *Kelly v. Robinson*, 479 U.S. 36 (1986).

11.7. Debts Non-Dischargeable Only On Timely Request of the Creditor

Section 523(c) provides that the exceptions to discharge in Section 523(a)(2), (4) and (6) only apply if the creditors timely requests a non-dischargeability determination – otherwise the debts will be discharged. Bankruptcy Rule 4007(c) requires the creditor to file a complaint objecting to the dischargeability of a debt within 60 days after the first date set for the meeting of creditors under Section 341. These rules apply to the following grounds for non-dischargeability:

Fraud – 11 U.S.C. § 523(a)(2).

The fraud exception covers two types of fraudulent conduct: financial condition fraud, and non-financial condition fraud. Misrepresentations of financial condition are only excepted from discharge if (1) in writing, (2) materially false, and (3) relied on by the creditor. Other kinds of fraudulent conduct need not be in writing, although materiality and reliance generally must be shown under non-bankruptcy law to establish any kind of fraud. Section 523(a)(2)(C) presumes fraud in two kinds of transactions incurred a short time before bankruptcy:

(1) Debts for luxury goods (not reasonably necessary for support) exceeding $600 to a single creditor within 90 days of bankruptcy;
(2) Debts for cash advances exceeding $875 within 70 days of bankruptcy.

Even outside the presumption, debtors who run up debts in anticipation of discharging the debts in bankruptcy (known as "loading up") have committed fraud and may face dischargeability complaints.

Fiduciary Fraud – 11 U.S.C. § 523(a)(4).

Debts for embezzlement, larceny and other defalcations by a fiduciary are not dischargeable. The issue in these cases often turns on whether the money was obtained with consent (a loan) or was obtained without consent (stolen). The Supreme Court's recent opinion on the requirements for fiduciary fraud is reprinted below.

Willful and Malicious Injury to Persons or Property – 11 U.S.C. § 523(a)(6).

Another recent opinion, reprinted below, requires the creditor to meet a high standard of proof in establishing maliciousness.

11.8. Cases on Exceptions to Discharge

11.8.1. FAHEY v. MASS. DEP'T OF REVENUE, 2015 BL 41157 (1st Cir. 2015)

The four bankruptcy appeals before us pose a single question of statutory interpretation: whether a Massachusetts state income tax return filed after the date by which Massachusetts requires such returns to be filed constitutes a "return" under 11 U.S.C. § 523(a) such that unpaid taxes due under the return can be discharged in bankruptcy. For the reasons set forth below, we conclude that it does not.

The facts in each of the four cases now on appeal are undisputed. John Brown, Brian Fahey, Anthony Gonzalez, and Timothy Perkins (the "debtors") all failed to timely file their Massachusetts income tax returns for multiple years in a row. This failure would not be a problem for them in these bankruptcy proceedings, but for the fact that they also failed to pay (either timely or otherwise) their taxes to the Massachusetts Department of Revenue. Eventually, each debtor filed his late tax returns, but still failed to pay all taxes, interest, and penalties that were due. More than two years later, they filed for Chapter 7 bankruptcy. The debtors seek a ruling that their obligation to pay the taxes they failed to pay is dischargeable. The Department argues for the opposite result; it contends unpaid taxes for which no return was timely filed by the Commonwealth's statutory deadline fit within an exception to discharge under 11 U.S.C. § 523(a)(1)(B)(i).

[Under 11 U.S.C. § 523(a)(1)] a tax is not dischargeable if the debtor failed to file a return, or if—perhaps anticipating bankruptcy—he filed the return late and within two years of his bankruptcy petition. Looking solely at the foregoing language, and using a common notion of what a "return" is, one could easily conclude that any return filed after the due date but more than two years before a bankruptcy filing would place the tax due under that return outside the section 523(a)(1) exception, and thus within the broad category of dischargeable debts. Prior to 2005, courts nevertheless attempted to fashion a definition of "return" that prevented debtors from relying on "bad faith" returns, or returns filed only after the taxing authority actually issued an assessment for taxes due in the absence of a tax return. See generally *Moroney v. United States* (*In re Moroney*), 352 F.3d 902, 905-06 (4th Cir. 2003) (providing examples of courts that determined late tax returns "filed after an involuntary assessment do not serve the purposes of the tax system, and thus rarely, if ever, qualify as honest and reasonable attempts to comply with the tax laws").

In 2005, Congress decided to define "return" on its own when it passed the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), making numerous revisions to section 523. Among the BAPCPA's changes was the insertion of a "hanging paragraph," denoted as section 523(a)(*), at the end of section 523(a). It provides:

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

Section 6020(a) returns are allowed only at the I.R.S.'s request and require the taxpayer's cooperation, while returns filed under section 6020(b) do not involve assistance by the taxpayer and may involve willful fraud.

So the question now presented is a question of statutory interpretation: Is a Massachusetts tax return filed after the due date for such returns a "return" as defined in section 523(a) so that the tax due under that return remains dischargeable

Read together, the hanging paragraph's definitional language and the "applicable" Massachusetts law control our decision. Under the hanging paragraph, for a document, whatever

it may be called, to be a "return," it must "satisf[y] the requirements of applicable nonbankruptcy law (including applicable filing requirements)." So the question is whether timely filing is a "filing requirement" under Massachusetts law. The answer is plainly yes.

The two other circuits to have decided this issue, albeit construing other jurisdictions' "applicable" filing deadlines, reached the same conclusion. The Tenth Circuit recently found returns filed late under the Internal Revenue Code not to be returns within the meaning of the hanging paragraph. *Mallo v. Internal Revenue Service*, 2014 WL 7360130, at *6 [774 F.3d 1313] (10th Cir. 2014) (explaining, in reference to the I.R.C.'s deadline for income tax returns, that "the phrase 'shall be filed on or before' a particular date is a classic example of something that must be done with respect to filing a tax return and therefore, is an 'applicable filing requirement'"). Similarly, the Fifth Circuit determined that a debtor's failure to comply with a Mississippi law stating that returns "shall be filed on or before April 15th" meant that the returns did not satisfy applicable filing requirements under the hanging paragraph's definition. *In re McCoy*, 666 F.3d 924, 928, 932 (5th Cir. 2012). And at least one other circuit court judge, in dictum, predicted such a result. *In re Payne*, 431 F.3d 1055, 1060 (7th Cir. 2005) (Easterbrook, J., dissenting) ("After the 2005 legislation, an untimely return cannot lead to a discharge—recall that the new language refers to 'applicable nonbankruptcy law (including applicable filing requirements).'").

The debtors nevertheless argue that the hanging paragraph's language is not quite so clear as to dictate our holding. Perhaps the term "applicable filing requirement" may acquire vagueness at the outer boundaries of its possible application. For example, is an instruction on an official form that the filer not staple the return together, or staple the check to the return, an "applicable filing requirement"? However one might answer that question, we do not see how there is any room for reasonable argument that, as a matter of plain language, a Massachusetts law setting the date when a tax return "is required to be filed" is somehow not a "filing requirement."

Widening the scope slightly, debtors point to the language of section 523(a)(1)(B)(ii) ("the two-year provision"), which clearly implies that there can be a "return" that is filed within two years "after the date on which such return… was last due." So the hanging paragraph cannot be read as entirely excluding the possibility that a late return can also be a "return." Grasping onto this point, the debtors contend (and the BAP agreed) that our interpretation would "vitiat[e] in its entirety" the two-year provision, rendering it "superfluous."

The defect in this argument is that the hanging paragraph itself carves out an exception from its general rule, deeming one type of late return to be a return. It specifies that "a return prepared pursuant to section 6020(a)… or similar State or local law" qualifies as a "return," while those prepared pursuant to section 6020(b) do not. Section 6020(a) and (b) can both be invoked when a taxpayer "fails to make" a proper return, including situations where the taxpayer is late in filing a return to the I.R.S. Therefore, a late tax return, if prepared in compliance with section 6020(a) and filed within two years of the bankruptcy petition, is still a return (and the tax due thus dischargeable), notwithstanding its failure to meet the otherwise "applicable filing requirement" of a mandatory deadline. While section 6020(a) may only apply in a small minority of cases, the fact that a late filed section 6020(a) return can still qualify as a "return" for section 523(a) purposes means that the two-year provision still has a role to play if the hanging paragraph's plain meaning controls.

The I.R.S.'s Chief Counsel has referred to the number of section 6020(a) returns as "minute" and in 2010 took the position that the safe harbor created by it was "illusory" because taxpayers have no right to demand a return under the provision. I.R.S. Chief Couns. Notice CC-2010-016 at 2-3 (Sept. 2, 2010). We accept the claim that such returns are rare, and are allowed only at the I.R.S.'s behest. It hardly follows, though, that the safe harbor expressly created for such returns is illusory. In fact, this "narrow safe harbor," was utilized by a debtor in a recent bankruptcy case where the bankruptcy court was bound by the reading of section 523(a)(*) that the Department urges here. See In re Kemendo, 516 B.R. 434, 438 (Bankr. S.D. Tex. 2014).

But, say the debtors, our reading of the hanging paragraph still renders unnecessary its last clause, stating that the term "return" does not include "a return made pursuant to [section 6020(b)] or a similar State or local law." The debtors are correct on this point. Nevertheless, we do not see this as the type of redundancy that invokes any effective application of the doctrine that we try to read statutes so that no section is superfluous. Here, in context, it simply appears that in creating an exception for section 6020(a), the drafters made clear (desiring a belt and suspenders) that they were not including its companion section 6020(b). Whatever one thinks of this redundancy, it offers too little to parry the force of the observation that a requirement to file on time is a filing requirement.

Moreover, were we to adopt the debtors' position that a law requiring compliance with a filing deadline is not a filing requirement, we would be left without any textual basis for distinguishing those filing requirements that count from those that do not. Instead—and debtors and the dissent are frank about this—we would be back to tinkering with subjective and conflicting judge-made rules. In that respect, we would render the principal thrust of the hanging paragraph to be largely of no effect. Of course, the debtors say that this is what Congress wanted, simply seeking to "confirm" pre-existing case law. But there was no such uniform rule in the case law to which the language in the hanging paragraph could be read as referring.

Sensibly anticipating weak support in the statutory and regulatory language, the debtors rely with much emphasis on three other rules of statutory construction.

First, they (and the amicus curiae) implore us to find instructive the notion that exceptions to discharge should be narrowly construed in the debtor's favor, and that the Bankruptcy Code should be read in light of its purpose to provide a fresh start to the "honest but unfortunate debtor." Second, the debtors attempt to frame our interpretation— particularly with respect to the limitations it imposes on the two-year provision's applicability—as representing a significant change to the pre-2005 Bankruptcy Code. Third, the debtors and amicus curiae call the result we reach here—that all late filed returns in Massachusetts are not subject to discharge in bankruptcy—"unfathomable" and its consequences "draconian" and "absurd."

Our response to the debtors' reliance on these rules of statutory construction is fourfold.

First, and most importantly, where the question is whether a Massachusetts law setting a date by which a tax return "is required to be filed" is a "filing requirement" under Massachusetts law, we find little need—or justification—for turning to secondary principles of statutory construction. Second, while the result we reach may be unfavorable towards delinquent taxpayers who are also bankrupt, there is hardly anything "unfathomable," "draconian," or "absurd" in the notion that Congress might disfavor debtors who both fail to pay their taxes and also fail to timely file the returns that would alert the taxing authority to the failure to pay. Finally, we acknowledge

that straightforward application of Congress's language changes presumed practice in some bankruptcy courts (including those that ruled for three of the debtors below). That being said, the judge-made law surrounding the meaning of a “return” in section 523(a) was far from settled.

For the foregoing reasons, we affirm the district court's judgment in favor of the Department. Summary judgment shall be entered in favor of the Department for the tax years at issue because the debtors’ tax liabilities were not discharged in bankruptcy as a matter of law.

11.8.2. BRUNNER v. NEW YORK STATE HIGHER EDUC. SERV. CORP., 831 F.2d 395 (2d Cir. 1987)

Marie Brunner, pro se, appeals from a decision of the District Court which held that it was error for the bankruptcy court to discharge her student loans based on "undue hardship," 46 B.R. 752 (Bankr.D.C.N.Y.1985). We affirm.

Whether not discharging Brunner's student loans would impose on her "undue hardship" under 11 U.S.C. § 523(a)(8)(B) requires a conclusion regarding the legal effect of the bankruptcy court's findings as to her circumstances.

[T]here is very little appellate authority on the definition of "undue hardship" in the context of 11 U.S.C. § 523(a)(8)(B). Based on legislative history and the decisions of other district and bankruptcy courts, the district court adopted a standard for "undue hardship" requiring a three-part showing: (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her 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 the debtor has made good faith efforts to repay the loans. [W]e adopt this analysis.

The first part of this test has been applied frequently as the minimum necessary to establish "undue hardship." Requiring such a showing comports with common sense as well.

The further showing required by part two of the test is also reasonable in light of the clear congressional intent exhibited in section 523(a)(8) to make the discharge of student loans more difficult than that of other nonexcepted debt. Predicting future income is, as the district court noted, problematic. Requiring evidence not only of current inability to pay but also of additional, exceptional circumstances, strongly suggestive of continuing inability to repay over an extended period of time, more reliably guarantees that the hardship presented is "undue."

Under the test proposed by the district court, Brunner has not established 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. She 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. In fact, at the time of the hearing, only ten months had elapsed since Brunner's graduation from her Master's 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. Judgment affirmed.

11.8.3. ELLINGSWORTH v. AT&T UNIVERSAL CARD SERV., 212 B.R. 326 (Bankr. W.D. Mo. 1997)

Ms. Ellingsworth and her husband filed their joint bankruptcy petition on November 25, 1996. According to their bankruptcy schedules Ms. Ellingsworth was indebted to AT&T Universal Card Services (UCS) for the sum of $4,038.11 at the time of filing. UCS issued a pre-approved credit card to Ms. Ellingsworth on October 19, 1995, with a credit limit of $4,000. Ms. Ellingsworth did not use the card from the time it was issued until September 11, 1996. Between September 11, 1996, and October 15, 1996, she took 16 cash advances totaling $3,411, and she made 8 purchases totaling $500.91. She made no payments to UCS before she and her husband filed their bankruptcy petition. Ten cash advances, totaling $2,058, excluding finance charges, were taken within 60 days of the bankruptcy filing. According to Mr. and Mrs. Ellingsworth's bankruptcy schedules, they had a total of $70,445 in unsecured debt at the time of filing. The vast majority of that debt is from 18 different credit cards.

[UCS filed a complaint claiming that the debt was non-dischargeable for fraud under Section 523(a)(2) of the Bankruptcy Code]. A trial was held on July 28, 1997. At the trial Ms. Ellingsworth testified that she is employed as a special education teacher, and has been so employed for 18 years. Her net monthly income is $2,111.48. She stated that she and Mr. Ellingsworth began to depend on their credit cards to make ends meet six years ago, prior to the birth of their third child. They had always been able to make the minimum payments on the credit card accounts, but eventually they began to max-out one card and shift to another. She claims they always believed they would be able to get out of debt, and they had never contemplated bankruptcy. They believed Mr. Ellingsworth was being groomed for a job promotion, but in August of 1996 he was demoted from a buyer to an assistant manager. While his salary declined by approximately $200 a month, the real decrease was in benefits. The company had supplied him with a car, insurance, and a gas allowance when he was a buyer. There was also the potential for a bonus each year as a buyer. As an assistant manager, Mr. Ellingsworth had to provide his own transportation necessitating the purchase of an automobile. His net monthly income is $1,186.69.

The Ellingsworths apparently began to use the UCS credit card when they encountered these additional expenses. Ms. Ellingsworth also testified that the cash advances she made with the credit card were to pay for food, medicines, and clothing. She referred to medical expenses for three children, but she admitted she had health insurance, and offered no documentation for money she claimed was paid for doctor's visits and medications. She said that at the time she began using the UCS card all of her other credit cards were at their limit. She also said that on October 15, 1996, after the last cash advance, she stopped using the card and made an appointment with Credit Counseling Services in order to develop a plan to get out of debt. I note that she was over her credit limit on the UCS card at the time she claims she voluntarily stopped using it. She stated that until she and Mr. Ellingsworth met with a counselor at Credit Counseling Services she had never contemplated filing for bankruptcy. They only filed their petition when they were told that they were in too much debt to benefit from counseling.

Don Carter, an employee, testified on behalf of UCS. He admitted that UCS contacted Ms. Ellingsworth in 1995 and informed her that she had been pre-approved for a card. She responded by telephone and was sent a credit card and a Universal Bank Credit Agreement (the Agreement). She never filled out an application for the card. Apparently she only verified by phone her income and employment. She was not asked about other liabilities. According to her bankruptcy schedules and the credit bureau report admitted at the trial, Ms. Ellingsworth and her husband already possessed at least 16 credit cards when she was offered the UCS card. Mr. Carter stated that UCS pre-approved Ms. Ellingsworth for its card based upon a credit score it obtained from a credit bureau. He stated that UCS obtained a Fair, Issacs Credit Bureau Score (a FICO score) of 759 on Ms. Ellingsworth prior to issuing her the card, and that any score above 680 merits consideration for a pre-approved card. He stated that UCS has developed some internal indicators that it uses in addition to the FICO score, but he was not certain of how the internal analysis is performed. And, other than the FICO score and the information provided by the customer as to her income and employment, it appears UCS had no other information available to it prior to issuing the card. According to Mr. Carter, once a card is issued to a customer, it is UCS policy to obtain a FICO score not less than every quarter, and to consider raising or lowering the credit limit or revoking the card, based on any changes. He said full credit bureau reports are not obtained prior to issuing cards because analyzing the credit bureau report itself would be too time consuming.

Mr. Carter testified that a full credit bureau report was generated on Ms. Ellingsworth on July 2, 1997, in preparation for this trial. That report showed her various obligations in detail. A casual reading of the report indicates that Ms. Ellingsworth is insolvent and unable to meet her obligations. UCS did not present any evidence that a quarterly credit score had been obtained on Ms. Ellingsworth between October of 1995, when she received the card, and July 2, 1997, when the credit bureau report was obtained.

UCS claims that Ms. Ellingsworth represented with each purchase and cash advance that she had the ability and the intent to repay her obligation to UCS. It also claims that any cash advances she took within 60 days of the bankruptcy filing aggregating more than $1,000 are presumed nondischargeable.

The dischargeability of credit card debt is but one small piece in the puzzle that represents unsecured lending today because the use of credit cards is, in fact, a form of unsecured lending. The following scenario illustrates this point. Assume you are a loan officer for a large metropolitan bank. A woman walks in one day and says she wants to borrow $60,000 on her signature. She willingly fills out a financial statement which shows that she already has $300,000 in unsecured debt, but she needs these additional funds for a business trip. She also shows one asset, a heavily encumbered apartment building that is being foreclosed. Of course, she promises to repay the loan if one is made to her. Would a bank that makes such a loan be found to have justifiably relied on her promise? Of course not.

But, what if, instead, the bank made the loan without bothering to ask her basic information about assets, liabilities, and income? And what if she did not make an express promise to repay the loan? Should this bank be allowed to claim that it justifiably relied on her implied promises to pay? One would think not. However, those are the very facts of a recent bankruptcy opinion, except that rather than a face to face encounter with a bank officer, the debt was incurred through use of a credit card. In *In re Hashemi*, [104 F.3d 1122 (9th Cir. 1996),] the debtor used his American Express Card to run up over $60,000 in debt while vacationing in France with his family. Dr.

Hashemi then came home and filed for bankruptcy protection. The Ninth Circuit held that the debt was nondischargeable. The opinion pays scant attention to whether American Express acted justifiably in relying on debtor's promise to pay, whether express or implied. The Court found only that when Dr. Hashemi began his spending spree his account balance was $227.00, and that he had often repaid balances in excess of $60,000 in the past. Nonetheless, surely if American Express had been aware of Dr. Hashemi's current situation, it would not have extended the credit. And, if it was not aware that Dr. Hashemi was insolvent, then it should have taken some steps to find out before extending such a large amount of credit. If no lender would have made that loan in a face to face transaction, why are American Express' unreasonable lending practices afforded special protection under the Bankruptcy Code? Is there something in the Bankruptcy Code that treats credit card loans differently from face to face loans?

Congress has created certain presumptions of nondischargeability as to credit card debt. To the extent those presumptions are applicable, a portion of Ms. Ellingsworth's debt is nondischargeable. However, to the extent there is not a presumption of nondischargeability, the conduct of UCS in making credit available to her is a significant factor, which renders that portion of her debt dischargeable.

I begin with some background regarding the explosive growth of pre-approved credit cards. I then find that UCS cannot justifiably rely on any representation made by Ms. Ellingsworth when UCS issued a pre-approved card to her unless UCS first obtained information as to her assets, liabilities, income, and expenses, and periodically updated that information. However, I also find that Ms. Ellingsworth did not intend to repay her obligation to UCS at the time she made the charges and took cash advances on the card. Finally, I find that Congress did intend to treat credit card cash advances differently from other credit card transactions if taken within the presumption period of 60 days prior to the bankruptcy filing. Therefore, to the extent any cash advances fall within the presumption period, I find that these debts are nondischargeable even though UCS did not prove justifiable reliance. To the extent the charges and cash advances were taken outside the presumption period, the lack of justifiable reliance requires a finding of dischargeability.

B. The Growth of Credit Card Use

In 1995 2.7 billion unrequested solicitations for credit cards were mailed to American consumers. That amounts to about 17 offers per adult. The average card has a spending limit of $6,007, therefore, if a consumer accepted every offer, she would end up with a potential credit line of $102,119. And, while the industry average for charging off credit card debt is 6 percent, bank profits have hit the highest levels in more than half a century, thanks primarily to the profits from credit cards. The average household carries about $4,000 a month in card debt, a total of $367 billion, and banks earned approximately $35 billion in interest on this total in 1995.

Since credit cards are so profitable, and the profits derive from having a very large customer base, issuers such as UCS may choose to ignore the usual standards of credit worthiness. Additionally, the creditors actively seek out undisciplined spenders who carry large unpaid balances from month to month. They dangle large credit lines in front of these consumers, and offer come-ons like lower interest rates for the first few months, as well as pre-printed cash advance checks. Some banks have even started to penalize consumers who pay their accounts in full each month. In their eagerness to capture market share, banks spend little time gathering financial information about their potential credit card customers. Prior to a mass mailing, creditors

such as UCS obtain lists from credit bureaus with the names of candidates and a "credit score" for each person on the list. These scores relate generally to past card use, whether the candidate pays the minimum monthly balance on current cards, and whether there are any delinquencies or bankruptcies on record. Car loans, medical bills, and mortgages are not included in the credit score, nor are income, job history, marital status, and assets.

The credit score, which can range from 450 to 850, is a supposedly scientific way of assessing the likelihood that a debtor will repay a loan. The computer credit model upon which most lenders rely today was developed by Fair, Issacs, and Company in California. The score is based on all credit-related data in a credit bureau report, but it is not a measure of a borrower's income, assets, or bank accounts. Fair Issacs, which is the service that UCS uses, identifies credit patterns, each of which corresponds to the probability that a lender [ed-borrower?] will make payments. The items are updated monthly, so the scores will change with new information.

By Mr. Carter's own admission it is more efficient for UCS to rely on a credit score than to acquire specific information about a potential customer prior to offering that customer a credit card. In other words, as long as you use a credit card instead of a financial statement to obtain an unsecured loan, you do not have to indicate any form of credit-worthiness, other than the fact that, until now, you have paid your bills on time. Unfortunately, this tactic guarantees that borrowers who are encouraged to use credit cards until they acquire unsecured debt that far exceeds their income will ultimately not be able to pay their bills on time.

Banks use other techniques as well to encourage consumers to keep large balances on their credit cards. For example, VISA and MASTERCARD issuer Citibank offer credit cards that give a 2 percent interest rate break to customers who keep a balance of more than $2,500. UCS, the plaintiff here, rewards customers with bonus points if they carry a large balance. More disturbing, credit card companies flood college campuses with sign-up tables to hook customers early in adulthood. It is not unusual for college students with no income at all to accumulate 10 to 15 cards while in college. Why do the credit card companies solicit college students who have no regular job, little income, and no credit history? Because market research indicates that consumers are likely to hang onto the first credit card they obtain and use it long after graduation. Moreover, they will make 77 percent of their monthly purchases with that card.

With this background, I turn now to how vast numbers of consumers are coping with such easy access to credit cards. Between April 1, 1996, and March 31, 1997, 830,921 consumers filed Chapter 7 bankruptcy petitions asking for the discharge of a total of $30 billion dollars in debt. Of that $30 billion dollars, $6 billion represented credit card debt.

The credit card issuers are lobbying Congress to tighten bankruptcy laws to deal with the massive amount of debt that is discharged each year. This approach, however, will not address the underlying problem. Credit card debt represents on average about 15 percent of a debtor's debt at the time of the bankruptcy filing. But this is rarely recently-acquired debt in anticipation of the filing. At least 25 percent of discharged debt is from consumers whose accounts had been current just prior to the filing.

One scholar has demonstrated that credit card operations are so much more profitable than other banking areas that lenders can relax their usual lending requirements, suffer a higher default rate, and still be money ahead. Which leads to the question in this case. **Can UCS sustain its**

burden to prove that Ms. Ellingsworth misrepresented her intent to repay its debt, and that it justifiably relied on that representation?

C. Section 523(a)(2)(A)

Section 523(a)(2)(A) of the Bankruptcy Code (the Code) excepts from discharge a debt for "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."

The United States Supreme Court recently held that section 523(a)(2)(A) encompasses common law misrepresentation or actual fraud. To prove actual or common law fraud, a creditor must prove the following:

(1) the debtor made a false representation;

(2) at the time the representation was made the debtor knew it was false;

(3) debtor subjectively intended to deceive the creditor at the time he made the representation;

(4) the creditor justifiably relied upon the representation; and

(5) creditor was damaged.[39]

While case law makes much of these five elements, most cases turn on **whether debtor's use of a credit card is an actual representation that she intends to repay the money borrowed**, and **whether the creditor justifiably relied** on debtor's representation that she intended to repay. It is rarely disputed that the debtor used the card, that the debt is being discharged because the debtor cannot pay the debt, and that the creditor is harmed.

In making its determination, the Court must, therefore, make a factual analysis of both the debtor and the creditor's conduct. In this case I will first look to Ms. Ellingsworth's conduct to discern her intent.

In the past, courts have held that a **debtor makes an implied representation with each use of a credit card that she has both the ability and intent to repay** the debt. The implied representation theory developed due to the unique nature of credit card transactions. Since a debtor presents a credit card to a third party merchant when making a purchase, not the issuer, Courts held that there could be no direct representation or contemporaneous reliance with each use of the card. Courts, therefore, held that with each use of the card, a debtor made an implied representation that she had the ability and intent to repay the debt.

With the advent of electronic transmission of credit card transactions, creditors are now instantly aware when a debtor uses its card. Therefore, debtors make an express representation to the issuer each time they use the card that they intend to repay the debt.

It is not clear if debtors ever made a representation of an ability to repay. However, as was recently pointed out by the Honorable Leif M. Clark, in the real world very few people who use credit cards represent a present ability to pay. They are using a credit card instead of cash precisely because they do not have the present ability to pay. It is this condition that allows card issuers to charge the interest and finance charges that make the credit card business so profitable. Judge Clark noted, ironically, that "an ability to repay is inferred to protect an industry that purposefully solicits customers who generally lack such ability."

A minority of Courts hold that the credit card company assumes the risk of nonpayment with the use of the card, unless the issuer told the debtor to stop using its card. Both the assumption of the risk theory and the implied representation theory were developed at a time when there was a significant lag between the time the card was used and the transaction was actually recorded with the issuer. Neither theory is as relevant today when most credit transactions are automatically recorded electronically at the instant the card is used. The issuer has the technology to refuse to accept the transaction before the merchant completes the sale. In fact, most merchants today will not complete the sale until they receive a code accepting the card. Likewise, if an issuer wishes to terminate the use of a card it can do so automatically. It does not have to inform the debtor to stop using the card, and then wait for it to be mailed back. **I, therefore, find that debtors make express representation that they intend to repay the obligation each time they use a credit card.**

With these fictional theories removed from the analysis, I must decide two things. Did Ms. Ellingsworth falsely represent to UCS that she intended to repay her obligation to UCS at the time she used the credit card, and did UCS justifiably rely on that representation.

Here, the Ellingsworths filed their Chapter 7 petition within 75 days of using the credit card for the first time. The majority of the cash advances were taken within 60 days of the filing. Between September 11, 1996, and October 15, 1996, Ms. Ellingsworth made 16 cash advances and 8 purchases totaling approximately $4,000. According to the bankruptcy schedules, the debtors had over $70,000 in unsecured debt at the time of filing. Ms. Ellingsworth testified that all of the other credit cards were "maxed out" when she began to use the UCS card, therefore, she and her husband had at least $65,000 in debt when the charges were made. Ms. Ellingsworth testified that she did not contact an attorney until she stopped using the UCS card. She did, however, state that she realized on October 15, 1996, that they could not go on using credit cards to meet their expenses, and that they needed credit counseling. She stated she and Mr. Ellingsworth made an appointment with Consumer Credit Counseling on October 18, 1996. The counselor at Consumer Credit Counseling told the debtors that they could not cut their expenses enough to service their debt, and that they should consider filing bankruptcy. According to the worksheet prepared by debtors and the counselor, debtors had net income of $4,180 and minimum living expenses of $3,383 leaving disposable income of $797. They needed $1465 a month to pay the minimum on their credit cards.

Ms. Ellingsworth testified that she voluntarily ceased using the UCS card before she went to credit counseling. I note, however, that she stopped using the card when she reached the credit limit. I also note that Mr. Ellingsworth testified that he contacted Consumer Credit Counseling long enough before their appointment to allow debtors to fill out all the financial information and return it to the counselor five days before their appointment. It appears, therefore, that debtors had determined they at least needed professional advice before they ceased using the UCS card.

They both insisted at trial that all of the charges were made for necessities. But, Ms. Ellingsworth could not explain a charge in the amount of $63.46 at Dave's Guns in Pataskala, Ohio, nor could she explain a charge in the amount of $217.23 at Golf Discount Campbell in Springfield, Missouri. Ms. Ellingsworth attempted to explain the medical expenses she encounters with three children, but she again failed to document these expenses. She admitted that they have health insurance that pays 80 percent of their health costs, and she did not refer to any specific illness that accounted for some of the funds she obtained with the UCS card.

Finally, I note that the debtors are intelligent and articulate people. They were not convincing when they said that, even though they had over $70,000 in unsecured debt, a second mortgage on their home, and had been using credit cards for six years to make ends meet, they didn't realize the extent of their financial difficulty until they went to client counseling. I especially note that the charges on the UCS card were made over a very short period of time and debtors stopped using the card as soon as the limit was reached. I, therefore, find that when Ms. Ellingsworth used the UCS card she knew that she would be unable to ever repay the debt, and she, therefore, did not intend to repay the debt.

A determination of intent, however, deals only with the debtor's conduct. I turn next to **whether UCS proved that it justifiably relied** upon Ms. Ellingsworth's representation of her intent to repay. The Supreme Court attempted to distinguish reasonable and justifiable reliance: Reliance may be justifiable even if it does not conform to the standard of a reasonable man. For example, a creditor may justifiably rely on a debtor's statement that his house is free and clear of liens, without going to the recorder of deeds office to check for itself. On the other hand, a creditor is "required to use his senses, and cannot recover if he blindly relies upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation." For example, the Supreme Court stated, if a seller represents that a horse is sound when it is apparent that it has one eye, the buyer cannot be said to have justifiably relied upon the representation. This clarification is not always apparent in the credit card context. The Restatement (Second) of Torts does instruct, however, that "justification is a matter of the qualities and characteristics of a particular plaintiff, and the circumstances of a particular case, rather than of the application of a community standard of conduct in all cases."

It becomes clear that UCS had access to much of the same information that is now available to this Court. Credit card issuers have come to rely on these factors when determining whether to object to the discharge of their debt after someone files for bankruptcy relief. Interestingly, rarely do creditors consider these factors prior issuing a card. Mr. Carter testified that UCS relied solely on these factors in determining whether to object to the discharge of Ms. Ellingsworth's debt. UCS, therefore, did not attend the section 341 meeting and it did not conduct a 2004 examination prior to filing the adversary proceeding.

Credit card issuers are very sophisticated creditors. They have instant electronic access each time a credit card is used now. They know the number of charges made in a given day, they know the amount of those charges, and they know when a customer exceeds his credit limit. While they do not know with each use whether a debtor is employed, the issuers could, and often choose not to, obtain updated information about debtor's employment status. Moreover, the issuers elect not to obtain any other financial information, including assets and liabilities, about potential customers at the time a pre-approved card is issued. Often the reaction of a creditor at the time a user exceeds the credit limit on his account is to increase the limit. Mr. Carter testified that on many accounts, UCS grants a gap over the limit, ostensibly to prevent embarrassing a customer by refusing to accept a charge if the limit has been exceeded. In *First USA Bank v. Hunter*, the Court noted that First USA extended an invitation to Mr. Hunter to accept its Platinum Card one week before the trial was to begin on its Complaint objecting to the discharge of its debt in Mr. Hunter's bankruptcy case. I also note that, while UCS has not offered Ms. Ellingsworth another pre-approved card, according to the Credit Bureau Report, **she has obtained four new credit cards since the bankruptcy filing**.

Thus, in order to determine if UCS justifiably relied on any representation of intent to repay Ms. Ellingsworth made before UCS extended her credit, I must first focus on the common sense actions of UCS while considering the qualities and characteristics of this creditor.

Ms. Ellingsworth did not request UCS's credit card. UCS, with all of the sophisticated tools of the credit scoring industry at its disposal, made a calculated decision to offer Ms. Ellingsworth its credit card with a $4,000 limit. Mr. Carter testified that UCS does not pull a credit bureau report on potential customers, because that would be too time consuming and costly. In other words, UCS never required so much as a signature from Ms. Ellingsworth acknowledging that she accepted all of the terms contained in the Agreement. Moreover, the Agreement authorizes UCS or its subsidiaries and affiliates "to make or have made any credit, employment, and investigative inquiries we deem appropriate related to this extension of credit, or the collection of amounts owed on your account." And, in preparation for this dischargeability proceeding, UCS did authorize a full Credit Bureau report.

Credit card issuers are sophisticated lenders. They make their decisions to offer customers credit cards not out of some altruistic notion of helping society, but because credit cards are very profitable. They carefully solicit customers who are most likely to use their services in a manner that increases those profits. They don't seek out or want customers who demonstrate an ability to pay by paying their other accounts in full each month. Judge Clark noted in *In re Hernandez* that one large credit card company makes $318 a year on the typical customer who carries a balance, while it loses $30 a year on customers who pay their monthly balance each month. A credit score demonstrates a likelihood a debtor will not default. It is not based upon an analysis of one's assets, secured liabilities, and living expenses. Mr. Carter admitted that credit scoring will not eliminate potential customers who are insolvent. In fact, Ms. Ellingsworth received a credit score, which was acceptable to UCS, at a time when, according to her bankruptcy schedules, the credit bureau report, and the information sheet from Consumer Client Counseling, her expenses exceeded her income by at least $500.00 a month.

Credit scoring reflects the practice of targeting individuals who use many credit cards and pay the minimum amount each month, rather than paying off their balance. Mr. Carter testified that a minimum payment on UCS's card is 2.1 percent of the outstanding balance each month. Surely UCS understands that customers with excess disposable income would not choose to make minimum payments leaving balances that incur interest in excess of 15 percent per annum. Offering this customer a pre-approved card, without making any individual inquiry into her financial status, is the equivalent of buying a horse with one eye. If the credit card issuers choose to continue this profitable technique to increase their customer base, they cannot claim that they justifiably relied upon any representation the customer made at the time the card was issued. In other words, a creditor cannot justifiably rely on any representation, or the absence thereof, made by a card holder if the card was pre-approved, and no direct financial information was obtained by the issuer.

Moreover, if UCS did not justifiably rely upon Ms. Ellingsworth's representations at the time the card was issued, reliance cannot then attach when the card is used. I find, therefore, that the credit in this case was extended to Ms. Ellingsworth without justifiable consideration of her ability to repay. If UCS did not consider her ability to repay, it certainly cannot now claim that it relied on her intent. Indeed, to hold otherwise only encourages creditors to continue to act irresponsibly. At the time debtor used the card, the only information UCS had obtained was

debtor's credit score as of a year before, her income, and her employment. Thus, UCS made the loan to debtor without consideration of her assets, her secured debt, or her other living expenses. Surely a bank that made an unsecured loan to a customer without obtaining such basic information could not be said to have justifiably relied on the debtor's representation that she intended to repay the debt. The issue, then, is whether a credit card company is entitled to more favorable treatment than a lender in a face to face transaction with a debtor. Which brings me to the presumption of nondischargeability in section 523(a)(2)(C).

D. Section 523(a)(2)(C)

Section 523(a)(2)(C) presumes the nondischargeability of cash advances exceeding a total of $1,000 taken within 60 days of filing:

The presumption is rebuttable. Congress adopted this provision to address what it considered an especially egregious form of behavior referred to as "loading up." Loading up is defined as "going on a buying spree in contemplation of bankruptcy." The Court in *In re Cox* found that the presumption in section 523(a)(2)(C) is the exclusive remedy against loading up. Only debt incurred within the 60 day period is subject to the presumption, but it can be rebutted if the debtor can demonstrate that the debt was not incurred in anticipation of a bankruptcy discharge. Furthermore, "debts incurred for expenses reasonably necessary for support of the debtor and the debtor's dependents" are not covered by the presumption.

Before discussing the issue of whether Ms. Ellingsworth and her husband successfully rebutted the presumption, I will discuss the effect of the presumption. The legislative history indicates that the presumption shifts the burden to the debtor to prove the dischargeability of a debt, as opposed to the burden resting squarely on the creditor to prove the nondischageability of a debt incurred outside the presumption period. This shift of the burden means "the reliance element inherent in section 523(a)(2)(A) is not relevant in the context of subsection 523(a)(2)(C)."Thus, if the debt is subject to the presumption, Congress has determined that it is the debtor's intent alone, and not the creditor's conduct, which determines dischargeability.

I note that Ms. Ellingsworth used her UCS card to make two purchases within 60 days of the filing, but the aggregate sum of those purchases was $61.94. Further, UCS did not claim the purchases were for luxury items. I, therefore, find the purchases do not fall within the ambit of section 523(a)(2)(C).

The cash advances, on the other hand, taken after September 25, 1996, total $2,058 (not including finance charges of $74.76),[91] and they, therefore, do represent debt that is presumed nondischargeable.

In attempting to rebut this presumption, Mr. and Mrs. Ellingsworth both testified that the cash advances were taken to pay reasonably necessary living and medical expenses for themselves and their three children. As discussed above, I have already found that Ms. Ellingsworth used her UCS card at a time when she could not have intended to repay the obligation.

The fact that the debt in this case resulted from cash advances also increases the sufficiency of the evidence necessary to rebut the presumption. [G]iven Congress' obvious abhorrence of "loading up," and the difficulty of proving what cash was used for, Congress may have intended cash advances to be nondischargeable if taken within the presumption period, regardless of how the money was used. I need not decide here whether the cash advance presumption can ever be

rebutted, since Ms. Ellingsworth did not offer sufficient evidence tracing the funds acquired by cash advance to reasonable living expenses. And, even if she had, I have found that she incurred the debt to UCS with the knowledge that she would not be able to repay it at some future time, and, therefore, with the intent not to repay.

E. Attorney's Fees

Mr. Carter testified that the cost to UCS of collecting this debt to date is $1,937.50.

It is not disputed that Ms. Ellingsworth defaulted under the terms of the Agreement, and that the Agreement provides for recovery of fees for any legal action. Therefore, any reasonable fees incurred in pursuing this adversary proceeding will be allowed. Ms. Ellingsworth did not object to the reasonableness of UCS's fees, therefore, UCS is allowed its attorney's fees in the amount of $1,937.50.

In sum, I find that the debt incurred for cash advances during the presumption period, in the amount of $2,058 is nondischargeable. The remainder is dischargeable. I further find that UCS is entitled to its attorney's fees and costs of collection in the amount of $1,937.50.

11.8.4. IN RE SHARPE, 351 B.R. 409 (Bankr. N.D. Tex. 2006)

[This] Adversary Complaint Objecting to Dischargeability of Debt [was] brought by Susan Baker. [It is] essentially a dispute between two parties, former friends, regarding various loans in the aggregate sum of $150,000 made by Ms. Baker to Mr. Sharpe in 2005. It was the undisputed testimony of the parties that Ms. Baker and Mr. Sharpe met sometime in December of 2004, shortly after Ms. Baker's divorce had become final, and that they became fast friends. Both parties, in fact, agreed that at one point their relationship could be fairly characterized as that of "best friends." During the period of their friendship, Ms. Baker and Mr. Sharpe spent a large amount of time together and spoke to each other most every day on the telephone.

Ms. Baker is, generally, a sophisticated woman. She testified that she has a high school degree, an undergraduate degree and a Master's degree. Ms. Baker had been married for 25 years upon her divorce and is the mother of three adult children. Her divorce from her one-and-only husband left her in a comfortable financial position, although she testified that she never informed Mr. Sharpe that she was well-off.

Mr. Sharpe's educational background was not defined at trial, but it is clear from his testimony that he had been involved for some time in various types of business speculation. Mr. Sharpe did testify on cross that, during the time frame in question, he had had drug and alcohol abuse problems and that he had not, as of the time of trial, been able to overcome such problems.

During the first part of 2005, Ms. Baker made two loans to Mr. Sharpe evidenced by promissory notes, and made several other loans not so documented. All of such loans, the parties agree, aggregate to $150,000. The loans were made starting late 2004 through August or September of 2005. Mr. Sharpe does not dispute that he took such loans and, in fact, scheduled Ms. Baker as an unsecured creditor in the amount of $175,000 describing the nature of her debt as a "personal loan." Ms. Baker is also listed on Mr. Sharpe's Schedule D as the holder of a purchase money security interest in the amount of $13,500 in a 2.87 carat diamond ring.

There was also testimony that Mr. Sharpe had, for some months, been preparing to file for bankruptcy protection. Mr. Sharpe's former office assistant, Eileen Wolkowitz, testified that Mr. Sharpe maintained a file into which bills were placed, which at her deposition she had referred to as a "bankruptcy file." She testified that Mr. Sharpe would instruct her not to pay certain bills as they came due. Ms. Wolkowitz also testified that there were times when she wanted to pay bills, but Mr. Sharpe would not let her. Ms. Wolkowitz testified that she and Mr. Sharpe did discuss the possibility that he might file for bankruptcy protection and further testified that the bankruptcy filing seemed like an inevitability to her. But she also testified that Mr. Sharpe never said that he was definitely going to file bankruptcy. An e-mail from Steve Smith to Mr. Sharpe, Plaintiffs Exhibit 8, reflects that at least as of September 6, 2005, Mr. Sharpe had been planning to file bankruptcy.

The parties agree that Mr. Sharpe dressed expensively at the time the loans were made, wearing custom-made suits and designer label clothes and accessories, and that he continues to so clothe himself today. Mr. Sharpe characterized his manner of dress as "dressing for success." Ms. Baker testified that Mr. Sharpe's manner of dress led her to believe that he was a wealthy man. She also testified that based upon his demeanor and appearance she thought he had money. Ms. Wolkowitz also testified that Mr. Sharpe led a lifestyle that led her to believe that he was a successful, wealthy person and that she believed Mr. Sharpe intended to lead people to believe that he was a wealthy person. There was testimony that Mr. Sharpe utilized an American Express card, which had his name on it, but was to an account belonging to a Johnny Vaughn, a friend of Mr. Sharpe, to make many extravagant purchases. Mr. Sharpe stipulated to the fact that high-dollar charges reflected on an American Express bill, Plaintiffs Exhibit 7, were his charges.

Next, Ms. Wolkowitz testified that, over the 11 years that she has known Mr. Sharpe, she has known him to make a lot of money and to have lost a lot of money. She also testified that his disposition is such that he often attempts and genuinely desires to do more than he is financially capable of doing. And, indeed, what is remarkable about Mr. Sharpe's testimony throughout the trial, though convoluted and often confused, is the sense of a desperate, "pie-in-the-sky" optimism on his part that maybe, someday things will work out his way and he will be as rich as he aspires to be.

The parties also agree that, in addition to dressing extravagantly, Mr. Sharpe lived extravagantly, flying on a business associate's Lear jet, dining in expensive restaurants (often with Ms. Baker in tow), drinking expensive wines, and shopping in designer boutiques and expensive stores, such as Cartier. Ms. Baker also presented photographs to the court one showing Mr. Sharpe beside a Lear jet and one of a mansion, as evidence that Mr. Sharpe wished to portray himself as a man of significant means. The photo of Mr. Sharp beside the Lear jet was captioned, "If you haven't had the opportunity to fly on a private jet I encourage you to make enough money to do so! No matter how good you think financial freedom is..... it's better!" There is no evidence as to the author of the caption, but Mr. Sharpe acknowledges that the photo appeared on his website and asserted that the photo was one of several photos that many people' took on that day in order to promote their business ventures and to generate leads for people interested in home-based businesses. He emphatically asserts that the photo was not used to defraud Ms. Baker of $150,000, but for business purposes in order to project an image that he is a mover and a shaker who could get deals done.

Finally, there was also undisputed testimony that Mr. Sharpe described himself on MySpace.com, at some point during 2006, as "Funny guy with killer body and money to burn seeks classy woman who doesn't believe everything she reads!" Ms. Baker emphasizes the phrase "money to burn;" Mr. Sharpe emphasizes the phrase "doesn't believe everything she reads!"

Ms. Baker also recounted, as evidence of Mr. Sharpe's extravagant bent, a particular evening out with Mr. Sharpe and other friends or associates at one of the Dallas/Fort Worth area's finer steakhouses, Del Frisco's Double Eagle Steak House (Del Frisco's). Ms. Baker testified that she became familiar with Mr. Sharpe's spending habits by watching him spend money, and that she knew that he would spend hundreds and hundreds of dollars on his frequent trips to Del Frisco's. Indeed, during the evening in question, Ms. Baker testified that Mr. Sharpe had ordered the most expensive bottle of wine the restaurant offered, a bottle priced at $15,000, and that Ms. Baker took it upon herself to approach the owner or manager of the restaurant to request that a less expensive bottle of wine be served instead. Upon Ms. Baker's request, a $5,000 bottle of wine was delivered for the evening's consumption.

Ms. Baker asserts that all of this evidence aggregates to show that Mr. Sharpe devised a scheme to portray himself as a wealthy man in order to con her into loaning him monies he knew he could not possibly repay. Ms. Baker represents that the clothing, the lifestyle, and all the trappings were part and parcel to Mr. Sharpe's having obtained money from her by false pretenses, false representations, or actual fraud. The lifestyle and all that went with it, Ms. Baker asserts, were designed to fool her into believing that Mr. Sharpe was a rich fellow who could easily take out loans and repay them. Ms. Baker asserts that Mr. Sharpe knew he was not financially secure, but held himself out, in word and deed, as if he were financially secure in order to obtain loans from her.

Mr. Sharpe, on the other hand, asserts that the extravagant purchases about which he and Ms. Baker testified, were not done in order to impress Ms. Baker so that he could obtain money from her, but were simply the way he had lived his life for many, many years. He acknowledged that he lived a very extravagant lifestyle, but it was never intended to defraud people.

Further to the allegations of false representations on the part of Mr. Sharpe is Ms. Baker's testimony that Mr. Sharpe had represented to her at the time the loans were made that he was able to repay the loans because he was essentially hiding assets from his second wife, Jennifer Sharpe, in order to prevent her from obtaining her share of those assets as part of the then-pending divorce settlement. Ms. Baker asserts that Mr. Sharpe told her that he had the funds to repay the loans at the time the loans were made and that he would repay Ms. Baker from such funds as soon as the divorce from Jennifer Sharpe was final.

Ms. Baker presented the court with no writing from Mr. Sharpe regarding this arrangement or these representations concerning his financial wherewithal to repay the loans. In connection with these allegations, the Plaintiff also elicited testimony from Ms. Wolkowitz that Mr. Sharpe put a business in Ms. Wolkowitz's name and generally wanted to avoid having things like credit cards in his name in connection with his pending divorce from Jennifer Sharpe. To the extent Mr. Sharpe represented that he had the funds to repay Ms. Baker hidden, and to the extent such arrangement to repay the loan upon the Sharpe divorce being final was made, it appears to the court that **such representations and arrangements were oral and were never evidenced by a writing**.

Mr. Sharpe has a very different story. While Ms. Baker asserts that Mr. Sharpe's dress, lifestyle, and demeanor were part of a scheme to defraud her (and, presumably, others), Mr. Sharpe asserts that the dress and the lifestyle were just how he lived his life and not part of some elaborate scheme. Mr. Sharpe absolutely disputes Ms. Baker's assertion that he represented to her that he was hiding funds in order to keep them out of his divorce settlement with Jennifer Sharpe. He denies ever making such a representation.

The court finds Ms. Baker's testimony concerning the proposed plan to repay the loans to be the most credible.

This court must determine whether, based upon the foregoing facts, the $150,000 debt owed by Mr. Sharpe to Ms. Baker is nondischargeable pursuant to section 523(a)(2)(A) of the Bankruptcy Code. Do the trappings of wealth, demeanor and an extravagant lifestyle, together with an oral representation by the Debtor that he has sufficient funds to repay a debt, rise to the level of false pretenses, false representation or actual fraud such that the debt is nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(A)?

Ms. Baker is hamstrung by the last clause of this provision, which — when read in conjunction with section 523(a)(2)(B) — requires that **a statement respecting the debtor's financial condition be in writing** in order to result in nondischargeability. Ms. Baker, by her own admission, relied upon Mr. Sharpe's oral representations that he had hidden away funds which were sufficient to repay Ms. Baker upon his divorce from Jennifer Sharpe. Ms. Baker, therefore, could not move under section 523(a)(2)(B) to seek nondischargeability of her debt — it requires a writing — and must move under section 523(a)(2)(A) and attempt to show this court that Mr. Sharpe's oral representations, together with his demeanor, lifestyle and the trappings of wealth, rise to the level of false pretenses, false representation, or actual fraud under section 523(a)(2)(A) in order that this court may find her debt nondischargeable.

In order to show a debt is nondischargeable under section 523(a)(2)(A), the creditor must show (1) that the debtor made representations **other than a statement concerning his financial condition**, (2) that at the time the debtor made the representations he or she knew they were false, (3) that the debtor made the representations with the intention and purpose to deceive the creditor, (4) that the creditor justifiably relied on such representations, and (5) that the creditor sustained losses as a proximate result of the false representations. [T]he court must determine that the plaintiff — in this case, Ms. Baker — justifiably relied upon the representations made to her by the defendant (Mr. Sharpe, herein). A plaintiff may not blindly rely upon a misrepresentation, the falsity of which would be obvious to the plaintiff had he or she used her senses to make a cursory examination or investigation.

This court finds that, during 2005, Mr. Sharpe lived a lifestyle and put forth a demeanor that suggested wealth. The expensive clothes, the expensive dinners, the extravagant spending, and all the rest were calculated by Mr. Sharpe to portray himself as a successful man of means. Mr. Sharpe characterizes this as "dressing for success" — and the court, having spent many years in private legal practice, certainly understands this maxim well. Ms. Baker sees a more sinister motive, one designed to dupe her (and, one presumes, others like her) into giving him large sums of money. The court also finds that Mr. Sharpe's concealment of his dire financial condition during 2005, and his, at least, vague intention to file bankruptcy — as reflected by the so-called

"bankruptcy file" — are also misrepresentations of his financial wherewithal to repay the loans to Ms. Baker.

But there is a problem with Ms. Baker's argument: the clothes, food, spending habits, et cetera **are all false representations concerning Mr. Sharpe's financial condition**. Patently, these do not fall within the ambit of section 523(a)(2)(A), which specifically excludes from it statements concerning a debtor's financial condition.

These representations pale, however, in comparison to the admitted linchpin representation to Ms. Baker: in obtaining from Ms. Baker, at least, the two large loans aggregating $95,000 in principal, Mr. Sharpe represented to her that he **had the funds available to repay her hidden away pending his divorce from Jennifer Sharpe.** In other words, the key misrepresentation that induced Ms. Baker to make the loans was Mr. Sharpe's oral representation to her that he had the funds to repay the loans, which he was hiding from his second wife pending their divorce, and that he would repay Ms. Baker's loans from such hidden funds upon the divorce becoming final. Regardless of all of the other testimony regarding extravagant lifestyle, clothing, and demeanor, Ms. Baker's unequivocal testimony is that the key inducement to her making the loans was Mr. Sharpe's **oral representations to her that he had the funds to repay her** and that he would repay her from such funds.

Every representation made by Mr. Sharpe to Ms. Baker in inducement of the loans was either explicitly or implicitly a representation concerning his financial condition. As such, they cannot form the basis of a cause of action under section 523(a)(2)(A).

For these reasons, the court concludes that it cannot provide relief to Ms. Baker under section 523(a)(2)(A). Mr. Sharpe's representations, though false, all concerned his financial condition, which fall under section 523(a)(2)(B), and which requires a writing to accord relief. For the foregoing reasons, Plaintiffs $150,000 debt is found to be dischargeable pursuant to section 523(a)(2)(A) and 523(a)(6) of the Bankruptcy Code.

11.8.5. ARCHER v. WARNER, 538 U.S. 314 (2003)

In late 1991, Leonard and Arlene Warner bought the Warner Manufacturing Company for $250,000. About six months later they sold the company to Elliott and Carol Archer for $610,000. A few months after that the Archers sued the Warners in North Carolina state court for (among other things) fraud connected with the sale.

In May 1995, the parties settled the lawsuit. The settlement agreement specified that the Warners would pay the Archers "$300,000.00 less legal and accounting expenses" "as compensation for emotional distress/personal injury type damages." It added that the Archers would "execute releases to any and all claims ... arising out of this litigation, except as to amounts set forth in [the] Settlement Agreement."

The Warners paid the Archers $200,000 and executed a promissory note for the remaining $100,000. The Archers executed releases "discharg[ing]" the Warners "from any and every right, claim, or demand" that the Archers "now have or might otherwise hereafter have against" them, "excepting only obligations under" the promissory note and related instruments.

The releases, signed by all parties, added that the parties did not "admi[t] any liability or wrongdoing," that the settlement was "the compromise of disputed claims, and that payment [was] not to be construed as an admission of liability. A few days later the Archers voluntarily dismissed the state-court lawsuit with prejudice.

In November 1995, the Warners failed to make the first payment on the $100,000 promissory note. The Archers sued for the payment in state court. The Warners filed for bankruptcy. The Bankruptcy Court ordered liquidation under Chapter 7 of the Bankruptcy Code.

And the Archers brought the present claim, asking the Bankruptcy Court to find the $100,000 debt nondischargeable, and to order the Warners to pay the $100,000. Leonard Warner agreed to a consent order holding his debt nondischargeable. Arlene Warner contested nondischargeability. The Archers argued that Arlene Warner's promissory note debt was nondischargeable because it was for "money ... obtained by ... fraud."

The Fourth Circuit, dividing two to one, [found the debt dischargeable]. The majority reasoned that the settlement agreement, releases, and promissory note had worked a kind of "novation." This novation replaced (1) an original potential debt to the Archers for money obtained by fraud with (2) a new debt. The new debt was not for money obtained by fraud. It was for money promised in a settlement contract. And it was consequently dischargeable in bankruptcy.

We agree with the Court of Appeals and the dissent that "[t]he settlement agreement and promissory note here, coupled with the broad language of the release, completely addressed and released each and every underlying state law claim." That agreement left only one relevant debt: a debt for money promised in the settlement agreement itself. To recognize that fact, however, does not end our inquiry. We must decide whether that same debt can also amount to a debt for money obtained by fraud, within the terms of the nondischargeability statute. Given this Court's precedent, we believe that it can.

Brown v. Felsen, 442 U.S. 127 (1979), governs the outcome here. [In that case, the parties to an action for fraud entered into a consent decree for the repayment of money. Instead of repaying, the debtor filed bankruptcy. The creditor Brown sought to except the debt from discharge due to the Debtor Felson's underlying fraud.]

This Court . . . conceded that the state law of claim preclusion would bar Brown from making any claim based on the same cause of action'" that Brown had brought in state court. But all this, the Court held, was beside the point. Claim preclusion did not prevent the Bankruptcy Court from looking beyond the record of the state-court proceeding and the documents that terminated that proceeding (the stipulation and consent judgment) in order to decide whether the debt at issue (namely, the debt embodied in the consent decree and stipulation) was a debt for money obtained by fraud.

As a matter of logic, *Brown's* holding means that the Fourth Circuit's novation theory cannot be right. The reduction of Brown's state-court fraud claim to a stipulation (embodied in a consent decree) worked the same kind of novation as the "novation" at issue here. Yet, in *Brown*, this Court held that the Bankruptcy Court should look behind that stipulation to determine whether it reflected settlement of a valid claim for fraud. If the Fourth Circuit's view were correct — if reducing a fraud claim to settlement definitively changed the nature of the debt for dischargeability purposes — the nature of the debt in Brown would have changed similarly, thereby rendering the debt dischargeable. This Court's instruction that the Bankruptcy Court could "weigh all the

evidence," would have been pointless. There would have been nothing for the Bankruptcy Court to examine.

Moreover, the Court's language in *Brown* strongly favors the Archers' position here. The Court said that "the mere fact that a conscientious creditor has previously reduced his claim to judgment should not bar further inquiry into the true nature of the debt." If we substitute the word "settlement" for the word "judgment," the Court's statement describes this case.

Finally, the Court's basic reasoning in Brown applies here. The Court pointed out that the Bankruptcy Code's nondischargeability provision had originally covered "only `judgments' sounding in fraud." Congress later changed the language so that it covered all such "`liabilities.'" This change indicated that "Congress intended the fullest possible inquiry" to ensure that "all debts arising out of" fraud are "excepted from discharge," no matter what their form. Congress also intended to allow the relevant determination (whether a debt arises out of fraud) to take place in bankruptcy court, not to force it to occur earlier in state court at a time when nondischargeability concerns "are not directly in issue and neither party has a full incentive to litigate them."

The only difference we can find between *Brown* and the present case consists of the fact that the relevant debt here is embodied in a settlement, not in a stipulation and consent judgment. But we do not see how that difference could prove determinative. The dischargeability provision applies to all debts that "aris[e] out of" fraud. A debt embodied in the settlement of a fraud case "arises" no less "out of" the underlying fraud than a debt embodied in a stipulation and consent decree. Policies that favor the settlement of disputes, like those that favor "repose," are neither any more nor any less at issue here than in *Brown*. In *Brown*, the doctrine of res judicata itself ensured "a blanket release" of the underlying claim of fraud, just as the contractual releases did here. Despite the dissent's protests to the contrary, what has not been established here, as in *Brown*, is that the parties meant to resolve the issue of fraud or, more narrowly, to resolve that issue for purposes of a later claim of nondischargeability in bankruptcy. In a word, we can find no significant difference between *Brown* and the case now before us.

Arlene Warner argues that we should affirm the Court of Appeals' decision on alternative grounds. She says that the settlement agreement and releases not only worked a novation by converting potential tort liabilities into a contract debt, but also included a **promise that the Archers would not make the present claim of nondischargeability for fraud**. She adds that, in any event, because the Archers dismissed the original fraud action with prejudice, North Carolina law treats the fraud issue as having been litigated and determined in her favor, thereby barring the Archers from making their present claim on grounds of collateral estoppel.

Without suggesting that these additional arguments are meritorious, we note that the Court of Appeals did not determine the merits of either argument, both of which are, in any event, outside the scope of the question presented and insufficiently addressed below. We choose to leave initial evaluation of these arguments to "[t]he federal judges who deal regularly with questions of state law in their respective districts and circuits," and who "are in a better position than we," to determine, for example, whether the parties intended their agreement and dismissal to have issue-preclusive, as well as claim-preclusive, effect, and to what extent such preclusion applies to enforcement of a debt specifically excepted from the releases. The Court of Appeals remains free, on remand, to determine whether such questions were properly raised or preserved, and, if so, to decide them.

We conclude that the Archers' settlement agreement and releases may have worked a kind of novation, but that fact does not bar the Archers from showing that the settlement debt arose out of "false pretenses, a false representation, or actual fraud," and consequently is nondischargeable.

JUSTICE THOMAS, with whom JUSTICE STEVENS joins, dissenting.

Remarkably the Court fails to address the critical difference between this case and Brown: The parties here executed a blanket release, rather than entered into a consent judgment. And, in my view, "if it is shown that [a] note was given and received as payment or waiver of the original debt and the parties agreed that the note was to substitute a new obligation for the old, the note fully discharges the original debt, and the nondischargeability of the original debt does not affect the dischargeability of the obligation under the note." *In re West*, 22 F.3d 775, 778 (7th Cir. 1994). That is the case before us, and, accordingly, Brown does not control our disposition of this matter.

Based on the sweeping language of the general release, it is inaccurate for the Court to say that the parties did not "resolve the issue of fraud." To be sure, as in Brown, there is no legally controlling document stating that respondent did (or did not) commit fraud. But, unlike in Brown, where it was not clear which claims were being resolved by the consent judgment, the release in this case clearly demonstrates that the parties intended to resolve conclusively not only the issue of fraud, but also any other "right[s], claim[s], or demand[s]" related to the state-court litigation, "excepting only obligations under [the] Note and deeds of trust." The fact that the parties intended, by the language of the general release, to replace an "old" fraud debt with a "new" contract debt is an important distinction from *Brown*, for the text of the Bankruptcy Code prohibits discharge of any debt "to the extent obtained by" fraud.

The Court today ignores the plain intent of the parties, as evidenced by a properly executed settlement agreement and general release, holding that a debt owed by respondent under a contract was "obtained by" fraud. Because I find no support for the Court's conclusion in the text of the Bankruptcy Code, or in the agreements of the parties, I respectfully dissent.

11.8.6. KAWAAUHAU v. GEIGER, 523 U.S. 57 (1998)

The question before us is whether a debt arising from a medical malpractice judgment, attributable to negligent or reckless conduct, falls within this statutory exception. We hold that it does not and that the debt is dischargeable.

In January 1983, petitioner Margaret Kawaauhau sought treatment from respondent Dr. Paul Geiger for a foot injury. Geiger examined Kawaauhau and admitted her to the hospital to attend to the risk of infection resulting from the injury. Although Geiger knew that intravenous penicillin would have been more effective, he prescribed oral penicillin, explaining in his testimony that he understood his patient wished to minimize the cost of her treatment.

Geiger then departed on a business trip, leaving Kawaauhau in the care of other physicians, who decided she should be transferred to an infectious disease specialist. When Geiger returned, he canceled the transfer and discontinued all antibiotics because he believed the infection had subsided. Kawaauhau's condition deteriorated over the next few days, requiring the amputation of her right leg below the knee.

Kawaauhau, joined by her husband Solomon, sued Geiger for malpractice. After a trial, the jury found Geiger liable and awarded the Kawaauhaus approximately $355,000 in damages. Geiger, who carried no malpractice insurance, moved to Missouri, where his wages were garnished by the Kawaauhaus. Geiger then petitioned for bankruptcy. The Kawaauhaus requested the Bankruptcy Court to hold the malpractice judgment nondischargeable on the ground that it was a debt "for willful and malicious injury" excepted from discharge by 11 U.S.C. § 523(a)(6).

The Bankruptcy Court concluded that Geiger's treatment fell far below the appropriate standard of care and therefore ranked as "willful and malicious."

Section 523(a)(6) of the Bankruptcy Code [excepts any debt] "(6) for willful and malicious injury by the debtor to another entity or to the property of another entity."

The Kawaauhaus urge that the malpractice award fits within this exception because Dr. Geiger intentionally rendered inadequate medical care to Margaret Kawaauhau that necessarily led to her injury. According to the Kawaauhaus, Geiger deliberately chose less effective treatment because he wanted to cut costs, all the while knowing that he was providing substandard care. Such conduct, the Kawaauhaus assert, meets the "willful and malicious" specification of § 523(a)(6).

We confront this pivotal question concerning the scope of the "willful and malicious injury" exception: Does § 523(a)(6)'s compass cover acts, done intentionally, that cause injury (as the Kawaauhaus urge), **or only acts done with the actual intent to cause injury**?

The word "willful" in (a)(6) modifies the word "injury," indicating that nondischargeability takes a **deliberate or intentional injury**, not merely a deliberate or intentional act that leads to injury. Had Congress meant to exempt debts resulting from unintentionally inflicted injuries, it might have described instead "willful acts that cause injury." Or, Congress might have selected an additional word or words, i. e., "reckless" or "negligent," to modify "injury." Moreover, as the Eighth Circuit observed, the (a)(6) formulation triggers in the lawyer's mind the category "intentional torts," as distinguished from negligent or reckless torts. Intentional torts generally require that the **actor intend "the consequences of an act**," not simply "the act itself."

The Kawaauhaus' more encompassing interpretation could place within the excepted category a wide range of situations in which an act is intentional, but injury is unintended, i. e., neither desired nor in fact anticipated by the debtor. Every traffic accident stemming from an initial intentional act—for example, intentionally rotating the wheel of an automobile to make a left-hand turn without first checking oncoming traffic—could fit the description. A "knowing breach of contract" could also qualify. A construction so broad would be incompatible with the "well-known" guide that exceptions to discharge "should be confined to those plainly expressed."

Finally, the Kawaauhaus maintain that, as a policy matter, malpractice judgments should be excepted from discharge, at least when the debtor acted recklessly or carried no malpractice insurance. Congress, of course, may so decide. But unless and until Congress makes such a decision, we must follow the current direction § 523(a)(6) provides.

11.8.7. BULLOCK v. BANKCHAMPAIGN, 133 S.Ct. 1754 (2013)

JUSTICE BREYER delivered the opinion of the Court.

Section 523(a)(4) of the Federal Bankruptcy Code provides that an individual cannot obtain a bankruptcy discharge from a debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."11 U.S.C. § 523(a)(4). We here consider the scope of the term "defalcation." We hold that it includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase. We describe that state of mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.

In 1978, the father of petitioner Randy Bullock established a trust for the benefit of his five children. He made petitioner the (nonprofessional) trustee; and he transferred to the trust a single asset, an insurance policy on his life. The trust instrument permitted the trustee to borrow funds from the insurer against the policy's value (which, in practice, was available at an insurance-company-determined 6% interest rate).

In 1981, petitioner, at his father's request, borrowed money from the trust, paying the funds to his mother who used them to repay a debt to the father's business. In 1984, petitioner again borrowed funds from the trust, this time using the funds to pay for certificates of deposit, which he and his mother used to buy a mill. In 1990, petitioner once again borrowed funds, this time using the money to buy real property for himself and his mother. Petitioner saw that all of the borrowed funds were repaid to the trust along with 6% interest.

In 1999, petitioner's brothers sued petitioner in Illinois state court. The state court held that petitioner had committed a breach of fiduciary duty. It explained that petitioner "does not appear to have had a malicious motive in borrowing funds from the trust" but nonetheless "was clearly involved in self-dealing." It ordered petitioner to pay the trust "the benefits he received from his breaches" (along with costs and attorney's fees). The court imposed constructive trusts on petitioner's interests in the mill and the original trust, in order to secure petitioner's payment of its judgment, with respondent BankChampaign serving as trustee for all of the trusts. After petitioner tried unsuccessfully to liquidate his interests in the mill and other constructive trust assets to obtain funds to make the court-ordered payment, petitioner filed for bankruptcy in federal court.

BankChampaign opposed petitioner's efforts to obtain a bankruptcy discharge of his state-court-imposed debts to the trust. And the Bankruptcy Court granted summary judgment in the bank's favor.

Petitioner in effect has asked us to decide whether the bankruptcy term "defalcation" applies "in the absence of any specific finding of ill intent or evidence of an ultimate loss of trust principal."

The lower courts have long disagreed about whether "defalcation" includes a scienter requirement and, if so, what kind of scienter it requires. In light of that disagreement, we granted the petition.

[In an omitted part of the opinion, the Court reviewed the historical use of “defalcation beginning with the 1867 Bankruptcy Act]. We base our approach and our answer upon one of this

Court's precedents. In 1878, this Court interpreted the related statutory term "fraud" in the portion of the Bankruptcy Code laying out exceptions to discharge. Justice Harlan wrote for the Court:

"[D]ebts created by `fraud' are associated directly with debts created by `embezzlement.' Such association justifies, if it does not imperatively require, the conclusion that the `fraud' referred to in that section means positive fraud, or fraud in fact, **involving moral turpitude or intentional wrong**, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality." *Neal v. Clark*, 95 U.S. 704, 709 (1878). We believe that the statutory term "defalcation" should be treated similarly.

Thus, where the conduct at issue does not involve **bad faith, moral turpitude, or other immoral conduct, the term requires an intentional wrong**. We include as intentional **not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent**. Thus, we include reckless conduct of the kind set forth in the Model Penal Code. Where actual knowledge of wrongdoing is lacking, we consider conduct as equivalent if the **fiduciary "consciously disregards" (or is willfully blind to) "a substantial and unjustifiable risk"** that his conduct will turn out to violate a fiduciary duty [**wilful blindness'**]. That risk "must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, **its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe** in the actor's situation."

Second, this interpretation does not make the word identical to its statutory neighbors. Nor are embezzlement, larceny, and fiduciary fraud simply special cases of defalcation as so defined. The statutory provision makes clear that the first two terms apply outside of the fiduciary context; and "defalcation," unlike "fraud," may be used to refer to nonfraudulent breaches of fiduciary duty.

Third, the interpretation is consistent with the longstanding principle that "exceptions to discharge `should be confined to those plainly expressed.'" In the absence of fault, it is difficult to find strong policy reasons favoring a broader exception here, at least in respect to those whom a scienter requirement will most likely help, namely nonprofessional trustees, perhaps administering small family trusts potentially immersed in intrafamily arguments that are difficult to evaluate in terms of comparative fault.

Finally, it is important to have a uniform interpretation of federal law, the choices are limited, and neither the parties nor the Government has presented us with strong considerations favoring a different interpretation.

In this case the Court of Appeals applied a standard of "**objectiv[e]** reckless[ness]" to facts presented at summary judgment. We consequently remand the case to permit the court to determine whether further proceedings are needed and, if so, to apply the heightened standard that we have set forth.

11.9. Reaffirmation – 11 U.S.C. § 524(c)

The discharge prevents a creditor from seeking to collect a discharged debt, but it does not prevent a debtor from voluntarily repaying a discharged debt. Debtors are free to voluntarily repay debts if they wish to do so. 11 U.S.C. § 524(f).

Creditors, of course, do not wish to rely on the debtor's good graces to collect debts, and would like to retain the ability to enforce collection. Before 1978, debtors could bind themselves by agreements made after discharge to reaffirm a debt, and thereby became obligated to repay the debt. One of the main reforms made in the Bankruptcy Code was to eliminate the debtor's unilateral ability to reaffirm a discharged debt.

The Bankruptcy Code requires reaffirmation agreements to be filed with the Court before the discharge is entered, after very substantial disclosures to the debtor about the risks of reaffirmation, and the approval of either the debtor's lawyer or the bankruptcy judge. 11 U.S.C. § 524(c) et seq. Absent the filing of a formal pre-discharge reaffirmation agreement, approved by the debtor's lawyer or the bankruptcy court, the debt is discharged and the obligation cannot be reinstated (although it can be voluntarily paid) by the debtor. Creditors who seek to enforce a post-discharge private reaffirmation agreement are in violation of the post-discharge injunction in 11 U.S.C. § 524(a).

The process of reaffirmation is cumbersome. Several pages of written disclosures must be given to the debtor in the form required by the Bankruptcy Code. 11 U.S.C. § 524(k). If the debtor is represented by counsel in the bankruptcy case, the debtor's counsel must sign a declaration or affidavit stating that (1) the debtor was fully informed of and voluntarily agreed to the terms (including the effect and consequences of default), and (2) the agreement does not impose an undue hardship on the debtor). 11 U.S.C. § 524(c)(3), 524(k)(4).

These reaffirmation rules often put the debtor and the debtor's lawyer in conflict, especially over reaffirming cars. Debtors often want to keep cars even though the debt exceeds the value of the car, and the debtor's lawyer has the unhappy burden of refusing to sign off. Some lawyers provide in their engagement agreements that they will not represent the debtor in connection with reaffirmations, so that the debtor can seek the approval or disapproval of the court (and possibly thereby limit the risk of an ipso-facto default and repossession under Section 521(a)(6) and 521(d) of the Bankruptcy Code.

Debtors who are not represented by counsel must obtain court approval for the reaffirmation agreement, with the bankruptcy court determining that the reaffirmation does not impose an "undue hardship" and is in the best interests of the debtor. 11 U.S.C. § 523(d). There is a presumption of undue hardship if the debtor's estimated future income does not exceed the debtor's future expenses by the amount of the required reaffirmed payments. 11 U.S.C. § 524(m)(1). The Debtor must rebut this presumption by explaining the additional source of funds that will be used to make the payments.

11.10. Practice Problems: Protecting the Discharge

Read Section 525 of the Bankruptcy Code and answer the following problems:

Problem 1. The local bar association has a policy of refusing to grant law licenses to applicants who have filed bankruptcy or have failed to repay discharged debts. Is that lawful? 11 U.S.C. § 525(a).

Problem 2. New York State has passed a law providing for the revocation of driving license privilege to any taxpayer who has failed to pay more than $10,000 in state income taxes.

May the state revoke the driver's license of a debtor who has filed bankruptcy and discharged the obligation to pay $12,000 in state income taxes? 11 U.S.C. § 525(a).

Problem 3. Last week, a former Chapter 7 debtor was offered a job at an insurance company. This week, the insurance company called the debtor and revoked the offer, saying that they discovered that the debtor had filed bankruptcy, and they have a policy against hiring bankrupts. Was it legal to withdraw the offer? *See* 11 U.S.C. § 525(b). *Compare* *Burnett v. Stewart Title, Inc.*, 635 F.3d 169 (5th Cir. 2011) (protections under § 525(b) apply only for existing employees, not job applicants); *Leary v. Warnaco, Inc.*, 251 B.R. 656 (S.D.N.Y. 2000) (statute prevents discrimination against job applicants).

Problem 4. Credit union employee tells credit union that he intends to file bankruptcy next week. Credit union promptly fires the employee. Can employee sue for violation of Section 525(b) of the Bankruptcy Code? *In re Majewski*, 310 F.3d 653 (9th Cir. 2002) (may fire employees for threatening to file bankruptcy; cannot fire employees for filing bankruptcy).

Problem 5. Debtor files bankruptcy owing $100,000 to creditors. Several creditors obtained guaranties from an insider of the debtor when the original loans were made. Can the creditors sue the insider on the guaranty after the debtor has filed bankruptcy? If the court determines that the suits against the insider will harm the debtor's reorganization effort, is there anything the court can do about the suits? *See* 11 U.S.C. § 105; *AH Robins Co., Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986) (the Court may issue or extend stays to enjoin a variety of proceedings [including discovery against the debtor or its officers and employees] which will have an adverse impact on the Debtor's ability to formulate a Chapter 11 plan.").

Problem 6. Debtor filed a Chapter 7 bankruptcy case on January 1, year 1, received a discharge on May 1, Year 1, and filed a new Chapter 7 case on January 2, Year 9. Is the debtor eligible for a discharge in the new case? 11 U.S.C. § 727(a)(8).

Problem 7. Debtor filed a Chapter 13 bankruptcy case on January 1, Year 1, and received a discharge on January 1, Year 5. Can the Debtor receive a discharge in a Chapter 7 case filed on January 2, Year 7? 11 U.S.C. § 727(a)(9).

Problem 8. Debtor filed a Chapter 7 case on January 1, Year 1, and received a discharge on May 1, Year 1. When would the debtor be eligible to receive a Chapter 13 discharge? 11 U.S.C. § 1328(f).

Chapter 12. Wage Earner Reorganizations under Chapter 13

12.1. Introduction

Individual debtors can technically file under either Chapter 11 or Chapter 13 (and Chapter 12 if they are small farmers or fishermen), but Chapter 11 is appropriate only for individual debtors who have substantial property and business holdings. Chapter 11 is expensive and complicated, and is suitable only for operating businesses that need more flexibility than Chapter 13 can provide (or for entities or larger businesses that are not eligible for Chapter 13). Chapter 13 is a simplified reorganization procedure for individuals (entities are not eligible) designed to be cost effective. This chapter will therefore focus on consumer reorganizations under Chapter 13 – with an emphasis on how Chapter 13 works, and who should consider Chapter 13 over Chapter 7. The next chapter will focus on business reorganization under Chapter 11.

12.2. Reasons for Filing under Chapter 13

There are three main benefits of Chapter 13 over Chapter 7.

Restructuring Secured Debts. First, debtors in Chapter 13 may restructure secured debts. In Chapter 7, debtors can only restructure secured debts with the creditor's agreement. In Chapter 7, the debtor must either surrender the collateral, redeem consumer goods by paying the secured claim in full, or live with the existing terms by reaffirmation or ride-through. With the exception of home mortgages and certain purchase money security interests, secured debts in Chapter 13 can be stripped down, the maturity date can be changed to coincide with the plan term, and the interest rate can be modified.

Keeping Non-Exempt Property. Second, debtors in Chapter 13 may keep their non-exempt property. In Chapter 7, the debtor must turn over non-exempt property to the trustee for liquidation and distribution to creditors. But debtors must pay a price for keeping all of their non-exempt property – debtors must pay unsecured creditors more than they would receive in a hypothetical Chapter 7 liquidation, and must pay unsecured creditors all of their "projected disposable income" during the term of the plan. The "projected disposable income" test is complicated by rules incorporating the dreaded Chapter 7 means test into the calculation.

Eligibility for a Discharge. Some debtors who would not qualify for Chapter 7 or a Chapter 7 discharge (due to the means test or the longer applicable period between discharges) may qualify for Chapter 13 and a Chapter 13 discharge.

12.3. The Chapter 13 Process

The process of Chapter 13 is very similar to the Chapter 7 process, except that the debtor's non-exempt property is not liquidated by a trustee. The debtor must file a petition and schedules containing the same basic information as required in Chapter 7. In addition, the debtor must file a plan of reorganization in compliance with Chapter 13's requirements. The plan must describe the

treatment of secured and unsecured claims during the plan period. Most jurisdictions require the use of a form plan of reorganization, making it easy for experienced local practitioners to locate the relevant terms added by the particular debtor.

The Court must hold a hearing to confirm the plan of reorganization. These hearings are often unopposed and perfunctory. Once the plan of reorganization is confirmed, the debtor will make the required play payments to the trustee, who will distribute the payments to the creditors who have timely filed proofs of claim. In some jurisdictions, the regular post-petition payments owing on secured claims are paid directly by the debtor to creditors outside of the plan (and thereby avoid being "taxed" by the Chapter 13 trustee's administrative fees). In other jurisdictions all payments to creditors during the plan flow through the trustee. Jurisdictions that impose trustee fees on all payments have a lower payment rate, which may actually benefit unsecured creditors. In all jurisdictions, if secured claims are restructured by the plan, the cure or restructured plan payments will go through the Chapter 13 trustee.

The debtor receives a discharge only after completing the payments required under the plan (or in some cases after failing to complete the plan if the requirements for a "hardship discharge" are met). What is discharged is the difference between the original debt and the payments called for by the plan during the term of the plan. In most cases, debtors who fail to complete the plan will either convert their cases to Chapter 7 or end up without a discharge.

12.4. The Chapter 13 Plan Term (and "Commitment Period")

The permitted plan "commitment period" is between 3 and 5 years, unless the debtor can pay all claims in full in less than 3 years. *See* 11 U.S.C. § 1325(b)(4)(B). Technically, below median debtors must ask the court for permission to propose a plan longer than 3 years, but this request is perfunctory and routinely granted. 11 U.S.C. § 1322(d)(2). Above median debtors **must** propose a five year plan. 11 U.S.C. § 1325(b)(4)(A)(ii).

12.5. Restructuring Secured Claims in a Chapter 13 Plan

Chapter 13 has different rules for restructuring different kinds of secured claims. Restructuring home mortgages is the most restrictive, followed by purchase money security interests in personal use property that was purchased within certain periods before bankruptcy. We will start with the general rules for restructuring secured claims and then look at the restrictions.

(a) General Restructuring Rules.

The basic rules for restructuring secured claims in Chapter 13 are set forth in Section 1325(a)(5) of the Bankruptcy Code. Unless the secured creditor consents (and of course **anything** can be done to the secured creditor with the secured creditor's consent), the debtor has three choices:

(1) Restructure. Pay the "value as of the effective date of the plan" of the "allowed secured claim" in **equal** monthly installments, in full, over the plan term (11 U.S.C. § 1325(a)(5)(B)). Here, the section 506(a) split takes on real meaning. The restructuring

option allows the debtor to strip down an undersecured creditor's claim to the value of the collateral. The Supreme Court in *Till v. SCS Credit*, reprinted below, determined that the "value as of the effective date of the plan" language in the statute requires the debtor to pay post-confirmation interest on that secured claim, but also set a post-confirmation interest rate that many consider to be beneficial to debtors. The debtor must be able to pay off the entire secured claim during the 3 to 5 year plan term.

(2) Surrender. Surrender the collateral to the secured creditor (11 U.S.C. § 1325(a)(5)(C);

or

(3) Cure and Reinstate. Cure the default over the plan term, and reinstate the original loan terms (11 U.S.C. §§ 1322(b)(3); 1322(b)(5)). This last option requires the debtor to pay off the arrearage plus make any current payments that are due during the life of the plan, so at the end of the plan term the loan is current. In all jurisdictions the cure payments are made through the Chapter 13 trustee. In some jurisdictions to regular post-petition payments may be made outside the plan to avoid the Chapter 13 Trustee's distribution fees.

Whether or not the debtor must pay interest on the cure amount depends on a number of factors. In *Rake v. Wade*, 508 U.S. 464 (1993), the Supreme Court ruled that post-confirmation interest had to be paid on the cure amount under the "value as of the effective date of the plan" language in Section 1325(a)(5), even though the home mortgage was not subject to modification under Section 1325(a)(5).

Then, in 1994, Congress enacted Section 1322(e), which is only applicable to loan agreements made after the date of enactment. Loans made prior to 1994 are still governed by *Rake v. Wade*. Section 1322(e) was intended to overrule *Rake v. Wade*, by allowing the creditor to collect interest on the cure amount only if the agreement AND applicable law require the payment of interest on cure amounts. In many cases, neither the loan documents nor state law provide specifically for interest to be paid on any missed payments in order to cure a default. Some courts have determined that no interest need be paid over the 3 to 5 year term on the arrearage that is being cured. *See In re Hoover*, 254 B.R. 492 (Bankr. N.D. Okla. 2000) (agreement did not permit interest on arrears, except for interest on insurance advance).

Curing property tax arrearages poses a special problem because of Section 511 of the Bankruptcy Code, which requires interest to be paid at the applicable non-bankruptcy rate on property tax claims whenever the code requires interest to be paid. Some courts have determined that interest must be paid on the tax arrearage being cured even through there is no contractual agreement to pay interest on cure amounts. *In re Meyhoefer*, 459 B.R. 167 (Bankr. N.D.N.Y. 2011).

(b) Limitation on Restructuring Home Mortgages.

Section 1322(b)(2) prohibits the debtor from restructuring "a claim secured only by a security interest in real property that is the debtor's principal residence." This has proven to be a significant limitation on the use of Chapter 13. Homeowners cannot strip undersecured mortgages, and cannot change the interest rate or term of the loan. Chapter 13 debtors can only force the mortgagee to accept a cure and reinstatement of a home mortgage – the debt cannot be stripped

under Section 506(a), and the terms cannot otherwise be changed. However, if the debt is secured by both the debtor's principal residence and other property, it can be restructured because it is not secured "only" by the principal residence. The courts are not in agreement on whether a mortgage covering a legal multiplex in which one of the units is occupied as a principal residence by the owner/debtor can be modified. Some courts have held that the mortgage is secured by both a principal residence and rental property, and therefore it may be modified. Other courts have held that the mortgage secures a single parcel that is occupied as a principal residence, and therefore cannot be modified. *Compare* *In re Scarborough*, 461 F.3d 406 (3d Cir. 2006) (multi-family property occupied in part may be modified in Chapter 13); *In re Macaluso*, 254 B.R. 799, 800 (Bankr. W.D.N.Y. 2000) (multi-family property partially occupied as a principal residence may not be modified in Chapter 13).

The limitation on restructuring home mortgages does not prevent the debtor from avoiding judicial liens that impair the debtor's exemption under Section 522(f). Moreover, as exemplified by *In re Pond* reprinted below, many courts have allowed "stripping off" wholly underwater junior mortgages in Chapter 13 on the grounds that they are not secured by an interest in the real property.

Creditors who are in arrears on a home mortgage, may cure the arrearages over time. This requires sufficient income to cure the default over the plan term (at most 5 years) in addition to making the regular required monthly payments. Restructured debts must be paid in full during the plan term, which because of the five year limitation poses significant problems for many debtors if the secured debts are large.

There is one exception to the rule that home mortgages cannot be modified. Section 1322(c)(2) allows modification of a home mortgage that matures by its own terms during the plan term. *See* *In re Paschen*, 296 F.3d 1203 (11th Cir. 2002). Despite the clear wording of the statute, one circuit has held that a maturing home loan cannot be stripped down under 506(a), but can only have its payment schedule modified. *In re Witt*, 113 F.3d 508 (4th Cir. 1997).

(c) Limitation on Restructuring Purchase Money Security Interests.

The so-called un-numbered "hanging paragraph" at the end of Section 1325(a) of the Bankruptcy Code (below 1325(a)(9)), contains important limitations on the restructuring of secured claims. The hanging paragraph applies to two kinds of **purchase money** secured claims:

(1) Motor vehicle loans, where the debt was incurred within **910 days** before bankruptcy, and the vehicle was acquired for the **personal use** of the debtor; and
(2) Other property where the debt was incurred within **1 year** of bankruptcy.

If the purchase money loan was incurred more than 910 days or 1 year, respectively, from the bankruptcy filing, the loan can be restructured under the general rule.

Consumer purchase money car loans incurred within 910 days, and other purchase money loans incurred within 1 year, before bankruptcy **cannot be stripped down** under Section 506(a). However, these loans may be restructured in other ways – the interest rate can be changed under *Till*, reprinted below, the maturity date can be changed to comport with the plan term, or the default can be cured under the plan.

12.6. Cases on Restructuring Secured Claims in Chapter 13

12.6.1. TILL v. SCS CREDIT CORP., 541 U.S. 465 (2004)

On October 2, 1998, petitioners Lee and Amy Till, residents of Kokomo, Indiana, purchased a used truck from Instant Auto Finance for $6,395 plus $330.75 in fees and taxes. They made a $300 down payment and financed the balance of the purchase price by entering into a retail installment contract that Instant Auto immediately assigned to respondent, SCS Credit Corporation. Petitioners' initial indebtedness amounted to $8,285.24 — the $6,425.75 balance of the truck purchase plus a finance charge of 21% per year for 136 weeks, or $1,859.49. Under the contract, petitioners agreed to make 68 biweekly payments to cover this debt; Instant Auto — and subsequently respondent — retained a purchase money security interest that gave it the right to repossess the truck if petitioners defaulted under the contract.

On October 25, 1999, petitioners, by then in default on their payments to respondent, filed a joint petition for relief under Chapter 13 of the Bankruptcy Code. At the time of the filing, respondent's outstanding claim amounted to $4,894.89, but the parties agreed that the truck securing the claim was worth only $4,000. In accordance with the Bankruptcy Code, therefore, respondent's secured claim was limited to $4,000, and the $894.89 balance was unsecured.

Petitioners' proposed debt adjustment plan called for them to submit their future earnings to the supervision and control of the Bankruptcy Court for three years, and to assign $740 of their wages to the trustee each month.

The proposed plan also provided that petitioners would pay interest on the secured portion of respondent's claim at a rate of 9.5% per year. Petitioners arrived at this "prime-plus" or "formula rate" by augmenting the national prime rate of approximately 8% (applied by banks when making low-risk loans) to account for the risk of nonpayment posed by borrowers in their financial position. Respondent objected to the proposed rate, contending that the company was "entitled to interest at the rate of 21%, which is the rate . . . it would obtain if it could foreclose on the vehicle and reinvest the proceeds in loans of equivalent duration and risk as the loan" originally made to petitioners.

At the hearing on its objection, respondent presented expert testimony establishing that it uniformly charges 21% interest on so-called "subprime" loans, or loans to borrowers with poor credit ratings, and that other lenders in the subprime market also charge that rate. Petitioners countered with the testimony of an economics professor, who acknowledged that he had only limited familiarity with the subprime auto lending market, but described the 9.5% formula rate as "very reasonable" given that Chapter 13 plans are "supposed to be financially feasible."

The Seventh Circuit majority held that the original contract rate should "serve as a presumptive [cramdown] rate," which either the creditor or the debtor could challenge with evidence that a higher or lower rate should apply.

The Bankruptcy Code provides little guidance as to which of the rates of interest advocated by the four opinions in this case—the formula rate, the coerced loan rate, the presumptive contract rate, or the cost of funds rate—Congress had in mind when it adopted the cramdown provision. That provision, 11 U.S.C. § 1325(a)(5)(B), does not mention the term "discount rate" or the word

"interest." Rather, it simply requires bankruptcy courts to ensure that the property to be distributed to a particular secured creditor over the life of a bankruptcy plan has a total "value, as of the effective date of the plan," that equals or exceeds the value of the creditor's allowed secured claim—in this case, $4,000. § 1325(a)(5)(B)(ii). A debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is always some risk of nonpayment. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for these concerns.

[We] reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. [Court discusses problems with each of the rejected approaches]

The formula approach has none of these defects. Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly. The appropriate size of that risk adjustment depends, of course, on such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. The court must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment. Some of this evidence will be included in the debtor's bankruptcy filings, however, so the debtor and creditors may not incur significant additional expense. Moreover, starting from a concededly low estimate and adjusting upward places the evidentiary burden squarely on the creditors, who are likely to have readier access to any information absent from the debtor's filing (such as evidence about the "liquidity of the collateral market." Finally, many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise. For these reasons, the prime-plus or formula rate best comports with the purposes of the Bankruptcy Code.

We do not decide the proper scale for the risk adjustment, as the issue is not before us. The Bankruptcy Court in this case approved a risk adjustment of 1.5%, and other courts have generally approved adjustments of 1% to 3%. Respondent's core argument is that a risk adjustment in this range is entirely inadequate to compensate a creditor for the real risk that the plan will fail. There is some dispute about the true scale of that risk—respondent claims that more than 60% of Chapter 13 plans fail, but petitioners argue that the failure rate for approved Chapter 13 plans is much lower. We need not resolve that dispute. It is sufficient for our purposes to note that, under 11 U.S.C. § 1325(a)(6), a court may not approve a plan unless, after considering all creditors' objections and receiving the advice of the trustee, the judge is persuaded that "the debtor will be able to make all payments under the plan and to comply with the plan." Together with the cramdown provision, this requirement obligates the court to select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan. If the court determines that the likelihood of default is so high as to necessitate an "eye-popping" interest rate, the plan probably should not be confirmed.

[The plurality then criticizes the dissent.] [I]n theory the formula and presumptive contract rate approaches would yield the same final interest rate. Thus, we principally differ with the dissent not over what final rate courts should adopt but over which party (creditor or debtor) should bear the burden of rebutting the presumptive rate (prime or contract, respectively).

JUSTICE SCALIA, with whom THE CHIEF JUSTICE, JUSTICE O'CONNOR, and JUSTICE KENNEDY join, dissenting.

My areas of agreement with the plurality are substantial. We agree that, although all confirmed Chapter 13 plans have been deemed feasible by a bankruptcy judge, some nevertheless fail. We agree that any deferred payments to a secured creditor must fully compensate it for the risk that such a failure will occur. Finally, we agree that adequate compensation may sometimes require an "`eye-popping'" interest rate, and that, if the rate is too high for the plan to succeed, the appropriate course is not to reduce it to a more palatable level, but to refuse to confirm the plan.

Our only disagreement is over what procedure will more often produce accurate estimates of the appropriate interest rate. The plurality would use the prime lending rate—a rate we **know** is too low—and require the judge in every case to determine an amount by which to increase it. I believe that, in practice, this approach will systematically undercompensate secured creditors for the true risks of default. I would instead adopt the contract rate—i. e., the rate at which the creditor actually loaned funds to the debtor—as a presumption that the bankruptcy judge could revise on motion of either party. Since that rate is generally a good indicator of actual risk, disputes should be infrequent, and it will provide a quick and reasonably accurate standard.

The prime rate becomes the objective tail wagging a dog of unknown size.

There is no better demonstration of the inadequacies of the formula approach than the proceedings in this case. Petitioners' economics expert testified that the 1.5% risk premium was "very reasonable" because Chapter 13 plans are "supposed to be financially feasible" and "the borrowers are under the supervision of the court." Nothing in the record shows how these two platitudes were somehow manipulated to arrive at a figure of 1.5%. It bears repeating that feasibility determinations and trustee oversight do not prevent at least 37% of confirmed Chapter 13 plans from failing. On cross-examination, the expert admitted that he had only limited familiarity with the subprime auto lending market and that he was not familiar with the default rates or the costs of collection in that market. In light of these devastating concessions, it is impossible to view the 1.5% figure as anything other than a smallish number picked out of a hat.

Based on even a rudimentary financial analysis of the facts of this case, the 1.5% figure is obviously wrong—not just off by a couple percent, but probably by roughly an order of magnitude. The first cost of default involves depreciation. The second cost of default involves liquidation. The third cost of default consists of the administrative expenses of foreclosure. I have omitted several other costs of default, but the point is already adequately made. The three figures above total $1,600. Even accepting petitioners' low estimate of the plan failure rate, a creditor choosing the stream of future payments instead of the immediate lump sum would be selecting an alternative with an expected cost of about $590 ($1,600 multiplied by 37%, the chance of failure) and an expected benefit of about $100 (as computed above). No rational creditor would make such a choice. In sum, the 1.5% premium adopted in this case is far below anything approaching fair compensation.

Given the inherent uncertainty of the enterprise, what heartless bankruptcy judge can be expected to demand that the unfortunate debtor pay triple the prime rate as a condition of keeping his sole means of transportation? It challenges human nature.

12.6.2. NOBELMAN v. AMERICAN SAVINGS BANK, 508 U.S. 324 (1993)

This case focuses on the interplay between two provisions of the Bankruptcy Code. The question is whether § 1322(b)(2) prohibits a Chapter 13 debtor from relying on § 506(a) to reduce an undersecured homestead mortgage to the fair market value of the mortgaged residence. We conclude that it does and therefore affirm the judgment of the Court of Appeals.

In 1984, respondent American Savings Bank loaned petitioners Leonard and Harriet Nobelman $68,250 for the purchase of their principal residence, a condominium in Dallas, Texas. In exchange, petitioners executed an adjustable rate note payable to the bank and secured by a deed of trust on the residence. In 1990, after falling behind in their mortgage payments, petitioners sought relief under Chapter 13 of the Bankruptcy Code. The bank filed a proof of claim with the Bankruptcy Court for $71,335 in principal, interest, and fees owed on the note. Petitioners' modified Chapter 13 plan valued the residence at a mere $23,500 — an uncontroverted valuation — and proposed to make payments pursuant to the mortgage contract only up to that amount (plus prepetition arrearages). Relying on § 506(a) of the Bankruptcy Code, petitioners proposed to treat the remainder of the bank's claim as unsecured. Under the plan, unsecured creditors would receive nothing.

The bank and the Chapter 13 trustee, also a respondent here, objected to petitioners' plan. They argued that the proposed bifurcation of the bank's claim into a secured claim for $23,500 and an effectively worthless unsecured claim modified the bank's rights as a homestead mortgagee, in violation of 11 U.S.C. § 1322(b)(2). The Bankruptcy Court agreed with respondents and denied confirmation of the plan. The District Court affirmed, as did the Court of Appeals.

Section 1322(b)(2), the provision at issue here, allows modification of the rights of both secured and unsecured creditors, subject to special protection for creditors whose claims are secured only by a lien on the debtor's home.

The parties agree that the "other than" exception in § 1322(b)(2) proscribes modification of the rights of a homestead mortgagee. Petitioners maintain, however, that their Chapter 13 plan proposes no such modification. They argue that the protection of § 1322(b)(2) applies only to the extent the mortgagee holds a "secured claim" in the debtor's residence and that we must look first to § 506(a) to determine the value of the mortgagee's "secured claim." Petitioners contend that the valuation provided for in § 506(a) operates automatically to adjust downward the amount of a lender's undersecured home mortgage before any disposition proposed in the debtor's Chapter 13 plan. Under this view, the bank is the holder of a "secured claim" only in the amount of $23,500 — the value of the collateral property. Because the plan proposes to make $23,500 worth of payments pursuant to the monthly payment terms of the mortgage contract, petitioners argue, the plan effects no alteration of the bank's rights as the holder of that claim. Section 1322(b)(2), they assert, allows unconditional modification of the bank's leftover "unsecured claim."

This interpretation fails to take adequate account of § 1322(b)(2)'s focus on "rights." That provision does not state that a plan may modify "claims" or that the plan may not modify "a claim secured only by" a home mortgage. Rather, it focuses on the modification of the "rights of holders" of such claims. By virtue of its mortgage contract with petitioners, the bank is indisputably the holder of a claim secured by a lien on petitioners' home. The term "rights" is nowhere defined in the Bankruptcy Code. In the absence of a controlling federal rule, we generally assume that Congress has "left the determination of property rights in the assets of a bankrupt's estate to state law," since such "[p]roperty interests are created and defined by state law. The bank's "rights," therefore, are reflected in the relevant mortgage instruments, which are enforceable under Texas law. They include the right to repayment of the principal in monthly installments over a fixed term at specified adjustable rates of interest, the right to retain the lien until the debt is paid off, the right to accelerate the loan upon default and to proceed against petitioners' residence by foreclosure and public sale, and the right to bring an action to recover any deficiency remaining after foreclosure. These are the rights that were "bargained for by the mortgagor and the mortgagee," and are rights protected from modification by § 1322(b)(2).

This is not to say, of course, that the contractual rights of a home mortgage lender are unaffected by the mortgagor's Chapter 13 bankruptcy. The lender's power to enforce its rights — and, in particular, its right to foreclose on the property in the event of default — is checked by the Bankruptcy Code's automatic stay provision. 11 U.S.C. § 362. In addition, § 1322(b)(5) permits the debtor to cure prepetition defaults on a home mortgage by paying off arrearages over the life of the plan "notwithstanding" the exception in § 1322(b)(2). These statutory limitations on the lender's rights, however, are independent of the debtor's plan or otherwise outside § 1322(b)(2)'s prohibition.

[T]o give effect to § 506(a)'s valuation and bifurcation of secured claims through a Chapter 13 plan in the manner petitioners propose would require a modification of the rights of the holder of the security interest. Section 1322(b)(2) prohibits such a modification where, as here, the lender's claim is secured only by a lien on the debtor's principal residence.

12.6.3. IN RE POND, 252 F.3d 122 (2d Cir. 2001)

We are asked to decide whether, under 11 U.S.C. § 1322(b)(2), Chapter 13 debtors can void a lien on their residential property if there is insufficient equity in the residence to cover any portion of that lien.

Defendants Charles Livingston, Jr. and Farm Specialist Realty hold a valid, duly recorded, mortgage lien for $10,630.58 on the principal residential property of plaintiffs Richard J. Pond and Lorrie A. Pond. On January 1, 1996, plaintiffs filed for bankruptcy under Chapter 13 of the Bankruptcy Code.

The Bankruptcy Court valued plaintiffs' residential property at $69,000. In addition, the Bankruptcy Court determined that there were four liens on the property, which had to be discharged in the following order of priority: (1) $1,505.18 for real property taxes; (2) $48,995.63 for the mortgage of the Farmers Home Administration; (3) $20,000 for the mortgage of the New York State Affordable Housing Corporation; and (4) $10,630.58 for defendants' mortgage. The

first three liens amounted to an encumbrance of $70,500.81; accordingly, plaintiffs' property, valued at $69,000, had insufficient equity to cover any portion of defendants' lien.

In August 1996, plaintiffs commenced this action to dissolve defendants' lien under 11 U.S.C. § 1322(b)(2). Plaintiffs argued that defendants' lien was wholly unsecured under 11 U.S.C. § 506 and, therefore, not entitled to the protection against modification under 11 U.S.C. § 1322(b)(2) accorded to claims "secured" solely by a debtor's principal residence. The Bankruptcy Court rejected this argument. It held that defendants' lien could not be modified under 11 U.S.C. § 1322(b)(2). The District Court reversed. It held that the statutory prohibition against modification does not apply to a holder of a wholly unsecured lien under 11 U.S.C. § 506, because such a lien is not "secured" by a residential property within the meaning of 11 U.S.C. § 1322(b)(2).

The question presented here is whether defendants' lien falls within the antimodification exception of Section 1322(b)(2) for claims "secured only by a security interest in ... the debtor's principal residence," because it is wholly "unsecured" under Section 506(a).

The Supreme Court in *Nobelman* held that, as long as some portion of the lien was secured by the residence, the creditor was a holder of "a claim secured only by ... the debtor's principal residence," and its rights in the entire lien were protected under the antimodification exception. Accordingly, the debtors' Chapter 13 plan could not void the unsecured component of the creditor's mortgage lien.

The *Nobelman* Court, however, left open the issue before us—namely, whether its holding extends to a holder of a wholly unsecured homestead lien. This issue has sharply divided bankruptcy and district courts, as well as bankruptcy scholars.

The majority view, which the District Court in the instant case adopted, is that the antimodification exception is triggered only where there is sufficient value in the underlying collateral to cover some portion of a creditor's claim. The courts that have espoused this position note, inter alia, that the Supreme Court in *Nobelman* first looked to Section 506(a) to determine whether any part of the creditor's claim was secured. Once the Court determined that the creditor's claim was at least partially secured under this provision, it held that the antimodification exception of Section 1322(b)(2) protected the creditor's rights in the entire claim. According to the majority view, therefore, the antimodification exception applies only where a creditor's claim is at least partially secured under Section 506(a).

A sizeable minority of courts, however, interprets *Nobelman* differently. According to these courts, *Nobelman* stands for the proposition that the value of the collateral underlying a lien is irrelevant to whether that lien is modifiable by a Chapter plan. Under this view, as long as the collateral underlying a lien is the debtor's principal residential property, the lien cannot be voided under Section 1322(b)(2) because to do so would modify the "rights of holders of ... a claim secured only by a security interest in ... the debtor's principal residence," 11 U.S.C. § 1322(b)(2).

Upon a review of the relevant statutory language, as well as the Supreme Court's decision in *Nobelman*, we agree with the majority view on this issue and therefore adopt it here. We conclude from [the Supreme Court’s language in *Nobelman*], as well as the language of the statute, that the antimodification exception of Section 1322(b)(2) protects a creditor's rights in a mortgage lien only where the debtor's residence retains enough value — after accounting for other encumbrances that have priority over the lien — so that the lien is at least partially secured under Section 506(a). We therefore join the Third, Fifth, and Eleventh Circuits, as well as the Bankruptcy

Appellate Panels of the First and Ninth Circuits, in holding that a wholly unsecured claim, as defined under Section 506(a), is not protected under the antimodification exception of Section 1322(b)(2).

12.6.4. Question: Is *IN RE POND* Still Good Law?

Consider the effect of the Supreme Court's decision in *Bank of America v. Caulkett*, 135 S.Ct. 1995 (2015), on the Court's reasoning in *In re Pond*. If wholly unsecured junior home mortgages cannot be stripped in Chapter 7 under 11 U.S.C. § 506(d), can an unsecured junior home mortgage be modified over the anti-modification rule in Section 1322(b)(2) as interpreted in *Nobelman*? So far, courts in the Second Circuit have distinguished the two cases, holding that *Caulkett* applies in Chapter 7, and *Pond* applies to wholly unsecured mortgages in Chapter 13. *See In re Orkwis*, 457 B.R. 243, 247 (Bankr. E.D.N.Y. 2011). There is also controversy about whether statutory liens on a home can be modified under Chapter 13. In *In re Walker*, Case No. 17-36804 (CGM) (Bankr. SDNY (2018), a bankruptcy court held that an IRS statutory lien could be split under Section 506(a) because the *Nobelman* rule was enacted to protect consensual mortgagees, not the IRS. Is that right?

12.7. Unsecured Claims in Chapter 13

The debtor must surmount the following hurdles in order to confirm a Chapter 13 plan if any creditor objects:

(1) Priority Claims Paid in Full.

Claims entitled to priority, with the exception of support claims that have been assigned to the government for collection, must be paid in full by the plan. 11 U.S.C. § 1322(a)(2). Assigned support claims must be paid in full unless the debtor has insufficient projected disposable income over a five year plan term to do so. 11 U.S.C. § 1322(a)(3). These provisions do not require the payment of interest on priority claims, but if the priority claims are not dischargeable in Chapter 13, the debtor will likely owe accruing interest at the end of the plan term under applicable non-bankruptcy law, and thus on the non-dischargeable claim. Also, interest on priority claims may be required in order to meet the "Best Interests of Creditors Test."

(2) Best Interests of Creditors Test.

The debtor must show that creditors are receiving more in **present value** under the plan than they would receive from the estate in a Chapter 7 liquidation case that occurred on the confirmation date. 11 U.S.C. § 1325(a)(4). This requires the debtor to perform a hypothetical liquidation to compare a Chapter 7 liquidation with the distribution under the plan. The plan distribution must be discounted to present value, presumably at the interest rate suggested in *Till v. SCS*.

Exemptions, which are normally irrelevant in Chapter 13 because the debtor may keep all property, exempt or not, become relevant when performing hypothetical liquidation analysis because you must calculate what creditors would have received in the hypothetical Chapter 7

liquidation occurring on the effective date of the plan. Exempt property would not have been distributed to creditors.

(3) Projected Disposable Income Test.

If any creditor objects to the plan, the court cannot confirm the plan unless it either pays unsecured creditors in full, or proposes to use all of the debtor's "projected disposable income" during the plan term to pay unsecured creditors. 11 U.S.C. § 1325(b)(1).

"Disposable income" starts with the debtor's "current monthly income" (which you will recall is the average prior six months of gross income used in the Chapter 7 means test – 11 U.S.C. § 101(10A)). Current monthly income is then reduced by either (1) reasonable living and business expenses for a **below median debtor** (11 U.S.C. § 1325(b)(2)), or (2) means test living and business expenses for an **above-median debtor** (11 U.S.C. § 1325(b)(3), which references 11 U.S.C. § 707(b)(2)(A) and (B)). The formula results in a hypothetical **net** monthly income which the debtor must pay to the trustee for unsecured creditor claims. The bankruptcy court has broad discretion to determine whether the below median debtor needs to incur all of the living expenses that the debtor proposes to pay after bankruptcy, which amounts are deducted by the formula above from the distribution that must be made to unsecured creditors during the plan term. The rigid means test in large measure replaces the judge's discretion for above-median debtors. Above-median debtors may ultimately be better off than below median debtors in proposing to pay secured claims after bankruptcy from money that could be used to make a larger distribution to creditors.

What if the debtor's current income is significantly different than it was during the six full months before bankruptcy? Given the specificity with which Congress defined "disposable income," one would assume changed circumstances for the better would result in a windfall for the debtor (allowing the debtor to keep the extra income rather than paying it to creditors), while changed circumstances for the worse may make it impossible for the debtor to make the required payments under the plan. The Supreme Court's decision in *Hamilton v. Lanning*, reprinted below, may surprise you as it did many of us in the bankruptcy community.

(4) Equal Treatment and Co-Debtor Exception.

As a general matter, similar priority claims must be treated the same way. There may be some small leeway for a debtor to separately classify non-priority unsecured claims through the reference in Section 1322(b)(1) to the Chapter 11 classification rule in Section 1122, but for the most part the debtor must treat general unsecured claims the same way. One explicit exception buried in the last phrase of Section 1322(b)(2) allows the debtor to prefer a consumer debt for which a co-debtor is also liable. This would allow, say, a consumer debt guaranteed by a family member to be paid in preference to other unsecured claims.

(5) Feasibility, Good Faith, and Post-petition Tax Returns.

The debtor must show that the plan is **feasible** (the debtor will be able to make the payments required by the plan) (11 U.S.C. § 1325(a)(6)); that the plan has been filed in **good faith** (11 U.S.C. § 1325(a)(7)); and that all **post-petition tax returns** that are due have been filed (11 U.S.C. § 1325(a)(8)).

12.8. Cases on Unsecured Claims in Chapter 13

12.8.1. HAMILTON v. LANNING, 560 U.S. 505 (2010)

Respondent had $36,793.36 in unsecured debt when she filed for Chapter 13 bankruptcy protection in October 2006. In the six months before her filing, she received a one-time buyout from her former employer, and this payment greatly inflated her gross income for April 2006 (to $11,990.03) and for May 2006 (to $15,356.42). As a result of these payments, respondent's current monthly income, as averaged from April through October 2006, was $5,343.70—a figure that exceeds the median income for a family of one in Kansas. Respondent's monthly expenses, calculated pursuant to § 707(b)(2), were $4,228.71. She reported a monthly "disposable income" of $1,114.98 on Form 22C.

On the form used for reporting monthly income (Schedule I), she reported income from her new job of $1,922 per month— which is below the state median. On the form used for reporting monthly expenses (Schedule J), she reported actual monthly expenses of $1,772.97. Subtracting the Schedule J figure from the Schedule I figure resulted in monthly disposable income of $149.03.

Respondent filed a plan that would have required her to pay $144 per month for 36 months. Petitioner, a private Chapter 13 trustee, objected to confirmation of the plan because the amount respondent proposed to pay was less than the full amount of the claims against her, see § 1325(b)(1)(A), and because, in petitioner's view, respondent was not committing all of her "projected disposable income" to the repayment of creditors, see § 1325(b)(1)(B). According to petitioner, the proper way to calculate projected disposable income was simply to multiply disposable income, as calculated on Form 22C, by the number of months in the commitment period. Employing this mechanical approach, petitioner calculated that creditors would be paid in full if respondent made monthly payments of $756 for a period of 60 months. There is no dispute that respondent's actual income was insufficient to make payments in that amount.

The parties differ sharply in their interpretation of § 1325's reference to "projected disposable income." Petitioner, advocating the mechanical approach, contends that "projected disposable income" means past average monthly disposable income multiplied by the number of months in a debtor's plan. Respondent, who favors the forward-looking approach, agrees that the method outlined by petitioner should be determinative in most cases, but she argues that in exceptional cases, where significant changes in a debtor's financial circumstances are known or virtually certain, a bankruptcy court has discretion to make an appropriate adjustment. Respondent has the stronger argument.

First, respondent's argument is supported by the ordinary meaning of the term "projected." Here, the term "projected" is not defined, and in ordinary usage future occurrences are not "projected" based on the assumption that the past will necessarily repeat itself. . . . While a projection takes past events into account, adjustments are often made based on other factors that may affect the final outcome. See *In re Kibbe*, 361 B.R. 302, 312, n. 9 (1st Cir. BAP 2007) (contrasting "multiplied," which "requires only mathematical acumen," with "projected," which requires "mathematic acumen adjusted by deliberation and discretion").

Second, the word "projected" appears in many federal statutes, yet Congress rarely has used it to mean simple multiplication.

By contrast, we need look no further than the Bankruptcy Code to see that when Congress wishes to mandate simple multiplication, it does so unambiguously— most commonly by using the term "multiplied."

Third, pre-BAPCPA case law points in favor of the "forward-looking" approach. Prior to BAPCPA, the general rule was that courts would multiply a debtor's current monthly income by the number of months in the commitment period as the first step in determining projected disposable income. But courts also had discretion to account for known or virtually certain changes in the debtor's income.

Pre-BAPCPA bankruptcy practice is telling because we "`will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.'" Congress did not amend the term "projected disposable income" in 2005, and pre-BAPCPA bankruptcy practice reflected a widely acknowledged and well-documented view that courts may take into account known or virtually certain changes to debtors' income or expenses when projecting disposable income. In light of this historical practice, we would expect that, had Congress intended for "projected" to carry a specialized—and indeed, unusual—meaning in Chapter 13, Congress would have said so expressly.

The mechanical approach also clashes repeatedly with the terms of 11 U.S.C. § 1325.

First, § 1325(b)(1)(B)'s reference to projected disposable income "to be received in the applicable commitment period" strongly favors the forward-looking approach. There is no dispute that respondent would in fact receive far less than $756 per month in disposable income during the plan period, so petitioner's projection does not accurately reflect "income to be received" during that period. The mechanical approach effectively reads this phrase out of the statute when a debtor's current disposable income is substantially higher than the income that the debtor predictably will receive during the plan period.

Second, § 1325(b)(1) directs courts to determine projected disposable income "as of the effective date of the plan," which is the date on which the plan is confirmed and becomes binding, see § 1327(a). Had Congress intended for projected disposable income to be nothing more than a multiple of disposable income in all cases, we see no reason why Congress would not have required courts to determine that value as of the filing date of the plan.

Third, the requirement that projected disposable income "will be applied to make payments" is most naturally read to contemplate that the debtor will actually pay creditors in the calculated monthly amounts. § 1325(b)(1)(B). But when, as of the effective date of a plan, the debtor lacks the means to do so, this language is rendered a hollow command.

The arguments advanced in favor of the mechanical approach are unpersuasive. Noting that the Code now provides a detailed and precise definition of "disposable income," proponents of the mechanical approach maintain that any departure from this method leaves that definition "`with no apparent purpose.'" This argument overlooks the important role that the statutory formula for calculating "disposable income" plays under the forward-looking approach. As the Tenth Circuit recognized in this case, a court taking the forward-looking approach **should begin by calculating disposable income, and in most cases, nothing more is required.** It is only in unusual cases that a court may go further and take into account other **known or virtually certain information about the debtor's future income or expenses**.

In cases in which a debtor's disposable income during the 6-month look-back period is either substantially lower or higher than the debtor's disposable income during the plan period, the mechanical approach would produce senseless results that we do not think Congress intended. In cases in which the debtor's disposable income is higher during the plan period, the mechanical approach would deny creditors payments that the debtor could easily make. And where, as in the present case, the debtor's disposable income during the plan period is substantially lower, the mechanical approach would deny the protection of Chapter 13 to debtors who meet the chapter's main eligibility requirements. Here, for example, respondent is an "individual whose income is sufficiently stable and regular" to allow her "to make payments under a plan," § 101(30), and her debts fall below the limits set out in § 109(e). But if the mechanical approach were used, she could not file a confirmable plan. Under § 1325(a)(6), a plan cannot be confirmed unless "the debtor will be able to make all payments under the plan and comply with the plan." And as petitioner concedes, respondent could not possibly make the payments that the mechanical approach prescribes.

Consistent with the text of § 1325 and pre-BAPCPA practice, we hold that when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation. We therefore affirm the decision of the Court of Appeals.

Justice SCALIA, dissenting.

The Bankruptcy Code requires a debtor seeking relief under Chapter 13, unless he will repay his unsecured creditors in full, to pay them all of his "projected disposable income" over the life of his repayment plan. 11 U.S.C. § 1325(b)(1)(B). The Code provides a formula for "project[ing]" what a debtor's "disposable income" will be, which so far as his earnings are concerned turns only on his past income. The Court concludes that this formula should not apply in "exceptional cases" where "known or virtually certain" changes in the debtor's circumstances make it a poor predictor. Ante, at 2471. Because that conclusion is contrary to the Code's text, I respectfully dissent.

The puzzle is what to make of the word "projected." In the Court's view, this modifier makes all the difference. Projections, it explains, ordinarily account for later developments, not just past data.

That interpretation runs aground because it either renders superfluous text Congress included or requires adding text Congress did not. It would be pointless to define disposable income in such detail, based on data during a specific 6-month period, if a court were free to set the resulting figure aside whenever it appears to be a poor predictor. And since "disposable income" appears nowhere else in § 1325(b), then unless § 1325(b)(2)'s definition applies to "projected disposable income" in § 1325(b)(1)(B), it does not apply at all.

The Court insists its interpretation does not render § 1325(b)(2)'s incorporation of "current monthly income" a nullity: A bankruptcy court must still begin with that figure, but is simply free to fiddle with it if a "significant" change in the debtor's circumstances is "known or virtually certain." That construction conveniently avoids superfluity, but only by utterly abandoning the text the Court purports to construe. Nothing in the text supports treating the definition of disposable income Congress supplied as a suggestion. And even if the word "projected" did allow (or direct) a court to disregard § 1325(b)(2)'s fixed formula and to consider other data, there would be no basis in the text for the restrictions the Court reads in, regarding when and to what extent a court

may (or must) do so. If the statute authorizes estimations, it authorizes them in every case, not just those where changes to the debtor's income are both "significant" and either "known or virtually certain." If the evidence indicates it is merely more likely than not that the debtor's income will increase by some minimal amount, there is no reading of the word "projected" that permits (or requires) a court to ignore that change. The Court, in short, can arrive at its compromise construction only by rewriting the statute.

Perhaps Congress concluded that other information a bankruptcy court might consider is too uncertain or too easily manipulated. Or perhaps it thought the cost of considering such information outweighed the benefits. In all events, neither the reasons for nor the wisdom of the projection method Congress chose has any bearing on what the statute means.

Unable to assemble a compelling case based on what the statute says, the Court falls back on the "senseless results" it would produce—results the Court "do[es] not think Congress intended." Even if it were true that a "mechanical" reading resulted in undesirable outcomes, that would make no difference. For even assuming (though I do not believe it) that we could know which results Congress thought it was achieving (or avoiding) apart from the only congressional expression of its thoughts, the text, those results would be entirely irrelevant to what the statute means.

[I]t requires little imagination to see why Congress might want to withhold relief from debtors whose situations have suddenly deteriorated (after or even toward the end of the 6-month window), or who in the midst of dire straits have been blessed (within the 6-month window) by an influx of unusually high income. Bankruptcy protection is not a birthright, and Congress could reasonably conclude that those who have just hit the skids do not yet need a reprieve from repaying their debts; perhaps they will recover. And perhaps the debtor who has received a one-time bonus will thereby be enabled to stay afloat. How long to wait before throwing the debtor a lifeline is inherently a policy choice.

Underlying the Court's interpretation is an understandable urge: Sometimes the best reading of a text yields results that one thinks must be a mistake, and bending that reading just a little bit will allow all the pieces to fit together. But taking liberties with text in light of outcome makes sense only if we assume that we know better than Congress which outcomes are mistaken. And by refusing to hold that Congress meant what it said, we deprive it of the ability to say what it means in the future. It may be that no interpretation of § 1325(b)(1)(B) is entirely satisfying. But it is in the hard cases, even more than the easy ones, that we should faithfully apply our settled interpretive principles, and trust that Congress will correct the law if what it previously prescribed is wrong.

12.8.2. IN RE GAMBOA, 538 B.R. 53 (Bankr. S.D. Cal. 2013)

The Chapter 13 Trustee has objected to confirmation of Debtors Chapter 13 plan and moved to dismiss their case. The central issue is whether Debtors may retain an income-producing property and cure the mortgage arrears on it through their plan. The court finds that they may not, and so sustains the Trustee's objection but denies his motion to dismiss.

Debtors' plan provides for four initial payments of $1,342.29 and then $975.29 per month for the remaining 56 months. This yields a 1.01 percent dividend to general unsecured claims. Debtors propose to retain an income-producing property located at 9092 Libra Drive, San Diego, California (the "Libra property"). The Libra property is a single-family residence encumbered by a mortgage with $49,811.15 in arrears. [The Debtors have no equity in the property]. They propose to pay all of the arrears through their plan. The mortgage payment on the rental property is $2,197.13 [and they receive monthly rent of] $2,250.00, creating a monthly positive cash flow of $52.87 by the property.

Debtors disregard the Trustee's central argument that retaining the rental property results in a net loss because they are paying both arrears on this mortgage through the plan as well as the mortgage outside the plan. The difference between the rent received ($2,250.00) and the sum of the monthly mortgage payment ($2,197.13) together with the arrears ($873.88 per month) leaves an $821.01 monthly deficiency — without accounting for maintenance costs or potential vacancies. Thus, Debtors would maintain ownership of the Libra property throughout the plan's life at a significant loss. Debtors' cash flow computation also overlooks likely future costs associated with maintaining the property. Further, Debtors' variable interest rate on their mortgage could well rise, given that current rates are near historic lows. Any one of these additional costs would easily absorb the rental's minimal revenue surplus. The court therefore finds that the property operates at a net loss.

Although Debtors focus on feasibility, the Trustee primarily objects to Debtors' retaining the Libra property on the theory that they are not applying all projected disposable income to the plan. A less than 100-percent plan is not confirmable unless a debtor applies all projected disposable income to it. 11 U.S.C. § 1325(b). Disposable income "means current monthly income received by the debtor . . . less amounts reasonably necessary to be expended for the maintenance or support of the debtor . . ." 11 U.S.C. §§ 1325(b)(2) and (3). Thus, a debtor has not applied all projected disposable income to the plan if he proposes a less than 100-percent plan and wishes to retain an unnecessary expense.

[For above-median debtors] Section 1325 provides that "amounts reasonably necessary to be expended... shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2)." 11 U.S.C. § 1325(b)(3). The statute envisions a "two-step inquiry." First, "if an expense is not reasonably necessary for the debtor's and/or dependents' maintenance and support, the inquiry ends at section 1325(b)(2) as there is no "amount" to determine." Id. But "[i]f the expense is reasonably necessary for the debtor's and/or dependents' maintenance and support, then section 1325(b)(3) requires the court to determine the amount in accordance with section 707(b)(2)." Id.

Ordinarily, a debtor who is current on a secured obligation may continue to make contractually scheduled payments and deduct them from current monthly income "regardless of whether the collateral is necessary." 11 U.S.C. § 707(b)(2)(A)(iii)(I). That same rule does not apply, however, to curing arrears on secured claims. 11 U.S.C. § 707(b)(2)(A)(iii)(II). Rather, Section 707(b)(2)(A)(iii)(II) limits "allowable cure payments to cure payments on necessary property." Debtors propose to pay both contractual payments and arrearages on the Libra property mortgage. The court must therefore determine whether maintaining the Libra Property is a reasonably necessary expense.

The Trustee draws an analogy between Debtors' effort to retain this property and a debtor proposing to fund a retirement account during a Chapter 13 plan. Courts generally hold that voluntary contributions to a pension fund or 401(k) account are not reasonably necessary expenses. The problem with such an investment is that while it may "enhance an individual's financial security," it does so impermissibly at the "expense of unpaid creditors."

The reasoning in these cases likewise applies to Debtors' proposal to retain this property and pay the arrears through their plan. They assert that the property is necessary to "permit them to live in modest comfort" after their case is over. And, they suggest, "holding onto this property ... in an improving market, could be ... a way of helping them make a fresh start." Prudent as this course may be, the Code does not allow debtors "to acquire financial security for the future at the expense of [their] unsecured creditors." Debtors' attempt to retain their investment would consume virtually all of their projected disposable income and excluded funds that they would otherwise contribute to their plan.

This results in a de minimis return to their creditors. It would be inequitable to allow Debtors to saddle their creditors with the burden of Debtors' financial investment while they obtain the benefits of a bankruptcy discharge. Retaining the Libra property is not a reasonably necessary expense since Debtors operate it at a loss and it is not their primary residence. As such, Debtors may not deduct the property's costs from their disposable income. The court sustains the Trustee's objection because Debtors have not applied all of their projected disposable income toward the plan. [Court denied dismissal of the case, allowing the debtor to propose another plan.]

12.9. Modification and Discharge. [12.10 – 12.11]

Confirmation of a Chapter 13 plan does not give the debtor a safe harbor against improving circumstances, nor does it protect creditors against declining circumstances. The debtor, the Chapter 13 Trustee or any unsecured creditor may ask the court to modify the plan to increase or decrease payments or make other changes that are appropriate in the light of changed circumstances. *See* 11 U.S.C. § 1329(a). The debtor remains under the scrutiny of the Chapter 13 trustee and the court until the plan is completed.

12.10. Practice Problems: Developing a Chapter 13 Plan

The following questions concern Abraham and Mary Lincoln, who have been married for many years, and have filed a joint Chapter 13 petition on January 1, 2015. Assume that the prime rate is 3.25%, and the *Till* rate in the local jurisdiction is 2% over prime (5.25%). Also assume that the Lincolns' "current monthly income" is above the median in the state.

Lincolns jointly own and reside in a home worth $109,000, which is subject to the three mortgages listed below. The mortgages mature in 15 years. The Lincolns want to keep their home. What is the least amount they will be required to pay each month to secured creditors as part of a Chapter 13 plan to keep their home?

A. Property Taxes: Interest accrues at 1% per month. Their annual property taxes are $3,500, and they are one year in arrears.
B. First Mortgage (HSBC): $110,000 payoff, $12,000 arrears, 9% contract rate, contract payments of $622/month. The loan documents do not say whether interest must be paid on arrearages to cure the default. Note that the payoff amount includes the arrearages.
C. Second Mortgage (Beneficial): $34,568 payoff, $5,000 arrears, 9.75% contract rate, contract payments of $344/month. The loan documents require interest to be paid on arrearages to cure a default.
D. The Lincolns also jointly own a rental property currently worth $60,000. Greentree Financial holds a first mortgage to secure a debt of $129,000. The promissory note requires payment of $1,202.82 per month and carries a 9.75% interest rate. The Lincolns are $15,000 in arrears. The rental income is $800 per month. They think the value of the property has bottomed and will be worth a lot more in the future, and would like to keep the property. How could the loan be restructured in Chapter 13 to minimize the total payoff cost, and what amount would they be required to pay each month to achieve that goal?
E. The Lincolns own two cars, both used for personal, family or household purposes. Abraham has a 2011 Ford Ranger purchased in September 2013, valued at $16,000. Ford Motor Credit holds a purchase money security interest ("PMSI") to secure a loan balance of $20,000. The Lincolns are $2,500 in arrears, and the contract interest rate is 17.5%, resulting in original payments of $519 per month. Mary has a 2009 Hyundai Elantra purchased 8/10/2009. The current value is $3,000, and the car is subject to a PMSI from Ally Financial with a loan balance of $5,000. The Lincolns are $750 in arrears, and the contract rate was 16.5%, and contract payments were $225.00 per month. The Lincolns would like to keep their cars. What can you do for them in Chapter 13, and how much will their payments be on each of the cars?
F. The Lincolns have furnished their home with living room and dining room furniture sets that they purchased from Rent-A-Center. They purchased the furniture 14 months ago for $9,000, paying $1,000 down and financing the $8,000 balance over 7 years at an interest rate of 22% per year, resulting in monthly payments of $187.41. The current loan balance is $7,356.41. The retail value of the used furniture is no more than $1,500. How much would they have to pay each month to keep the furniture?
G. During the six month period before bankruptcy, Abraham slipped while shoveling snow from his driveway and broke several of his ribs. As a result, Abraham was out of work on disability during three of the six full months preceding the bankruptcy filing. As a result of Abraham's reduced income while on disability, the Debtors had average gross income during the six full months before bankruptcy (CMI) of $4,000 per month, which includes the $800 per month in rental income that they received from the rental property. Abraham is now back at work, and the Lincolns now have gross wage income of $5,100 per month, plus the $800 per month in rental income.

H. Assume that the Lincolns will have to pay $3,500 to their bankruptcy attorney in monthly installments for Chapter 13 legal services.

I. Each Chapter 13 Trustee charges a commission rate, set by the United States Trustee, on all money that is distributed to creditors by the Chapter 13 Trustee. In some jurisdictions, all payments (secured and unsecured) go through the Chapter 13 trustee. In other jurisdictions, the debtor pays directly the debtor's regular post-petition secured debt payments, while cure payments, restructured loan payments and unsecured distributions go through the Chapter 13 trustee. For the purpose of calculating the actual distribution to creditors, and meeting the best-interests-of-creditors test, assume that the Chapter 13 Trustee's commission rate is 10% on any distributions paid by the Chapter 13 trustee to creditors, and that the local jurisdiction allows ordinary debt service payments (but not cure and restructuring payments) to be paid directly to the creditors, bypassing the Chapter 13 trustee.

Problem 1. Calculate the Lincolns' "disposable income" using the statutory formula in Section 1325(b), assuming that they are going to keep all of their property (either by restructuring or curing the secured claims, as allowed). Also consider whether an adjustment would be appropriate in calculating "**projected** disposable income" under *Hamilton v. Lanning*. In making your calculations, assume that the IRS would allow monthly expenses under the National Standards and Local Standards under Section 707(b)(2)(A)(ii) of $2,000 per month. Note also that debtors are entitled to deduct debt service payments under Section 707(b)(2)(A)(iii) in arriving at "disposable income" (or projected disposable income) under Section 1325(b)(3).

Problem 2. If the trustee or a creditor objects to the plan on the grounds that the expenses of keeping the rental property are not necessary in accordance with *In re Gamboa*, above, can you make a statutory distinction supporting the debtor's plan to keep the rental property? Would the result be different if the Lincolns were below median debtors?

Problem 3. Calculate the distribution to unsecured creditors under the Chapter 13 plan that you have developed. Assume that the Debtors have general unsecured debts totaling $100,000, not counting any of the secured or priority debts listed above.

Problem 4. Explain how the monthly payment would change under the facts in Problem (1) if Abraham used the Ford Ranger for work. Do not change your remaining calculations for the plan.

Problem 5. In addition to the above facts, assume that the Lincolns own a 20 acre parcel of undeveloped land in Onondaga County that is free and clear of liens. The Lincolns believe that the land may have great value when the western United States runs out of water and those residents migrate back to the Syracuse area. The Lincolns claim that the land could be liquidated for $39,000 after sales commissions. A creditor has objected to the plan claiming that the property could be liquidated for $42,000. Explain whether confirmation depends on the value of the property? *See* 11 U.S.C. § 1325(a)(4).

Chapter 13. Business Reorganizations under Chapter 11

13.1. Introduction to Chapter 11 of the Bankruptcy Code

Chapter 11 is a very flexible chapter for reorganizing businesses. Because of the chapter's flexibility, it is also very expensive. Chapter 11 is designed to be a negotiated plan with the creditors. It provides for negotiating the plan terms with the relevant class of creditors, and for a voting mechanism to bind minority creditors who are not willing to go along with the will of the majority. Chapter 11's fundamental purpose is to address the holdout problem – the problem that some minority creditors will always hold out for a better deal – that often prevents an out-of-court workout from proceeding.

We begin by understanding the plan process: what provisions must be contained in a disclosure statement and plan, how the plan is negotiated, and how does the voting process work. We will then look at the requirements for confirming the plan, including the so-called "cramdown" for confirming a plan over the objection of an impaired class of creditors. Finally, we will consider a popular method of reorganization that avoids the strictures of Chapter 11 – the pre-plan bankruptcy sale of the debtor's entire business to a new entity. This procedure was recently employed by giant corporations like General Motors and Chrysler at the federal government's behest. We will consider whether such sales are consistent with the purposes of Chapter 11.

13.2. The Chapter 11 Process

The Chapter 11 process generally begins very much like a Chapter 7 case. The Debtor files a petition and schedules closely mirroring the ones the debtor would file in Chapter 7. Unlike Chapter 7, however, a trustee is not automatically appointed to take control of and liquidate the debtor's assets. Instead, the individual debtor in an individual case, or the prepetition management of the debtor in an entity case, continue to operate the business in Chapter 11 as a "debtor in possession." Except for the right to compensation, the debtor in possession has the powers under the Bankruptcy Code given to a trustee. 11 U.S.C. § 1107(a). The court retains the power to appoint a Chapter 11 trustee for "cause" or in the best interests of the estate (11 U.S.C. § 1104(a)), but Chapter 11 trustees are the exception not the rule.

The official committee of unsecured creditors, consisting of the seven creditors holding the largest claims who are willing to serve, is organized by the United States Trustee, and serves to balance and operate as a check on the powers of the debtor in possession. 11 U.S.C. § 1102(b)(1). The members of the official committee are fiduciaries acting on behalf of all unsecured creditors, and will generally retain counsel at the expense of the debtor's estate to review and monitor the debtor in possession's activities. The creditors' committee can seek the appointment of a Chapter 11 trustee if the committee loses confidence in the debtor in possession's management, and the committee plays an important role in the plan negotiation process.

In an appropriate case, the Court can appoint additional official committees who are entitled to administrative claims against the bankruptcy estate for their costs and attorney fees – to represent other constituents in the case (such as stockholders, bondholders, secured creditors, etc.).

Unofficial committees are often formed by interested groups to act jointly in the case to protect their own interests. Unofficial committees must show that they have rendered benefit to the estate in order to recover their costs and fees from the bankruptcy estate as an administrative expense.

If there are doubts about the debtor in possession's honesty or competence, the Court can upon request appoint an examiner – a professional (usually lawyer, business expert or accountant) – to review a particular issue or more broadly consider whether to recommend the appointment of a Chapter 11 trustee. 11 U.S.C. § 1104(c).

One can imagine that the costs of multiple sets of professionals reviewing each other's work can quickly skyrocket, which is one reason that large Chapter 11 cases are so expensive. The bankruptcy court has to carefully consider the size and complexity of the case in deciding whether multiple official committees are appropriate.

13.3. The Exclusivity Period

Only the debtor in possession can file a plan of reorganization during the exclusivity period. This gives the debtor in possession a great deal of power in the Chapter 11 process by requiring all creditors and equity security holders to negotiate with the debtor in possession for a reorganization plan. Once the exclusivity period ends, any party in interest can file a plan (including a liquidating plan), which can promptly doom the reorganization.

The initial exclusivity period is **120 days** from the filing of the case for the debtor to propose a plan, and **180 days** from the filing of the case to confirm a plan. 11 U.S.C. § 1121(b) and (c).

In the early days of the Bankruptcy Code, the bankruptcy court could extend the exclusivity period indefinitely, and in large cases often did so right at the beginning of the case to center negotiating authority with the debtor in possession. However, in 2005 Congress amended the Bankruptcy Code to put real limits on the bankruptcy court's power to extend the exclusivity period: the 120 day period to propose a plan cannot be extended beyond **18 months** from the filing date, and the 180 day period to confirm a plan timely filed cannot be extended beyond **20 months** from the filing date. 11 U.S.C. § 1121(d)(2).

The exclusivity period also ends automatically if a Chapter 11 trustee is appointed. 11 U.S.C. § 1121(c)(1).

13.4. Negotiating a Plan and the Disclosure Statement

The Bankruptcy Code prohibits a plan proponent from soliciting acceptance or rejection of a plan unless the proponent provides the solicitee with a copy of the plan and a bankruptcy-court-approved disclosure statement. 11 U.S.C. § 1125(b). Strict adherence to this rule would put the cart before the horse, because one would have to complete the plan and obtain court approval for the disclosure statement before negotiating the plan terms with creditors. As long as a formal vote is not being solicited, a plan proponent may have general discussions about plan terms with

creditors without violating the rule. Care must be taken during planning stages not to seek formal voting commitments during the negotiations.

After some general negotiations, the plan proponent must draft a plan of reorganization and disclosure statement. The disclosure statement is like a security prospectus – it must contain "adequate information" which is defined in the Bankruptcy Code as all information that a reasonable investor typical of holders of claims and interests would require to make an informed judgment in voting on the plan. Unlike security offerings outside of bankruptcy, however, the proponent does not have to make a guess about what information need be disclosed and then bear the risk of a lawsuit if the information is deficient. Instead, the proponent must obtain the bankruptcy court's approval for the disclosure statement, and is protected from later claims of deficiency as long as the disclosure statement was submitted in good faith. *See* 11 U.S.C. § 1125(e).

The process of seeking approval of a disclosure statement is rather convoluted because of the prohibition against seeking acceptances before the disclosure statement has been approved by the bankruptcy court. The plan proponent files the proposed plan and disclosure statement with the bankruptcy court, and sets a date for the hearing on the disclosure statement. The disclosure statement and plan can only be mailed out to the debtor, trustee, the committees and the SEC. Creditors and other parties in interest just get a notice stating the hearing date, the deadline for filing objections to the proposed disclosure statement, and that the proposed disclosure statement is available from the court or will be sent to anyone else who in writing requests a copy. Only those who request a copy of the proposed disclosure statement will receive one. *See* Bankruptcy Rule 3017.

Proper objections at the disclosure statement stage are only to the adequacy of disclosure, not the merits of the plan itself. Parties in interest who believe that the disclosure statement contains insufficient disclosure or is confusing can ask for additional disclosure or clarification before the statement is approved by the Court. Courts are liberal in requiring additional disclosure or clarification. Some courts will consider the merits at the disclosure statement stage if, under a summary judgment type standard, the plan is not confirmable on its face. Arguments about confirmation that depend on the result of the votes, of course, are not proper at the disclosure statement stage and should be held for the confirmation hearing after the voting has occurred.

It is common for additional modifications to be made to the disclosure statement both before the disclosure statement hearing, and after in response to the bankruptcy court's requirements.

After the bankruptcy court approves the proposed disclosure statement, an order approving the disclosure statement, setting the date for the confirmation hearing, the deadline for filing objections to confirmation, and the deadline for submitting a ballot, along with the approved disclosure statement, plan of reorganization, ballot and voting instructions is mailed to all creditors and parties in interest. The plan proponent then receives and tabulates the ballots. If sufficient votes are obtained for confirmation, the case proceeds to confirmation. If not, the proponent can start over.

The confirmation hearing can be a full blown trial on whether the requirements for confirmation can be met, or can be a rather simple affair if there are no major contests. Some judges accept an offer of proof and confirm the plan if the requirements are met and there is no

material opposition. Other judges require the proponent to call witnesses and prove each of the requirements for confirmation even in the absence of a material objection. Confirmation is governed by Section 1129 of the Bankruptcy Code, which we will review in some detail.

After confirmation, the plan goes into effect. Entities receive an immediate discharge of all debts not provided for by the plan. 11 U.S.C. § 1141(d)(1). As in Chapter 13, individuals receive a discharge only upon completing the plan. *See* 11 U.S.C. § 1141(d)(5).

The normal process of confirmation is very time consuming. The proponent must give at least 28 days' notice of the hearing on the disclosure statement, and an additional 28 days' notice for the hearing on confirmation. 11 U.S.C. § 2002(b). Objections and modifications slow the process down even further.

Many companies believe that the stigma of being in bankruptcy will harm their ability to do business, and want to be in and out of bankruptcy as quickly as possible. One popular method for minimizing the time in bankruptcy is the pre-packaged plan of reorganization, permitted by Section 1125(g) of the Bankruptcy Code

The idea of a pre-pak is to negotiate the plan terms before filing bankruptcy, obtain sufficient consents from creditors to meet the confirmation requirements before filing bankruptcy, and then file the petition with the consents and proceed immediately to confirmation avoiding the disclosure statement process entirely. *See* 11 U.S.C. § 1125(g). The difficulty is that the bankruptcy court must find in hindsight that the pre-bankruptcy disclosure and solicitation complied with the Bankruptcy Code's disclosure statement requirements (and complied with applicable non-bankruptcy law – law that generally does not exist) – otherwise the solicitation must start over under the bankruptcy court's supervision. *Id*.

13.5. Classification

At the core of Chapter 11 is the classification and voting process. The plan must put creditors in classes, provide for the treatment of the claims in each class, solicit votes from the creditors in each class, and obtain the votes of the requisite class majorities to obtain class acceptance. The plan can be confirmed only if all classes accept with the requisite majorities, or the debtor can satisfy the "cramdown" requirements with respect to each class that does not accept by the requisite majorities. *See* 11 U.S.C. § 1129(a)(8), (b)(1).

Section 1122 contains the main rule on classification. It requires claims that are not "substantially similar" to be placed in separate classes. Secured claims are not "substantially similar" to unsecured claims. First priority secured claims are not "substantially similar" to second priority secured claims. Secured claims against one property are not substantially similar to secured claims against another property. Thus, secured claims must be put in their own separate classes, unless they are secured by the same property and in the same priority (like bonds).

Priority claims must be separately classified according to their priority, except for some unexplained reason administrative claims, gap claims, and tax claims which cannot be classified at all. *See* 11 U.S.C. § 1123(a)(1). Often plans will list these claims in "non-classified classes."

The Bankruptcy Code allows the creation of a small claims class for administrative convenience. 11 U.S.C. § 1122(b). These claims can be treated better than other general unsecured claims.

The main area of classification dispute concerns whether general unsecured claims can be separately classified for strategic reasons. Section 1122 of the Bankruptcy Code requires separate classification for different claims, but it does not prohibit separate classification for similar claims. The common law has restricted the separate classification of similar claims made for strategic purposes (usually to meet the confirmation requirement in Section 1129(a)(10) of the Bankruptcy Code that one impaired class vote for the plan). The rules on separately classifying similar claims are set forth below in the *US Truck* and *Bernard Steiner* cases. The main classification controversy discussed in the *Greystone* and *SM 103* cases concerns whether the huge unsecured deficiency claim of a secured creditor under 506(a) can or must be separately classified from the claims of other general unsecured creditors. In large real estate cases, the answer to the question may dictate whether the debtor can reorganize under Chapter 11 or not.

13.6. Voting and Impairment

A class of creditors accepts the plan if **at least 2/3 in amount** of claims and **more than 1/2 in number** of creditors in the class, who vote, vote to accept the plan. Only those who vote count in the denominator – non-voters are ignored. 11 U.S.C. § 1126(c). Both the amount and number requirements must be met for acceptance. Only the 2/3 in amount requirement applies to interest holders (2/3rds of shares, for example). 11 U.S.C. § 1126(d). The court can exclude the vote of anyone who did not vote in good faith, or whose votes were not solicited or procured in good faith. 11 U.S.C. § 1126(e).

Two other rules are important. Classes who are **unimpaired** are deemed to accept the plan, and classes who **receive or retain nothing** under the plan are deemed to reject the plan. 11 U.S.C. § 1126(f), (g). The concept of impairment is a technical one. With one exception, any change in the claimant's (or interest holders) legal, equitable or contractual rights – whether for the better or worse – is an impairment. 11 U.S.C. § 1124(1). The one exception is that the curing of a default can leave the creditor unimpaired if the creditor is both cured and compensated for the default, and the creditor's legal, equitable and contractual rights are not otherwise affected. 11 U.S.C. § 1124(2).

13.7. Non-Recourse Debt and the 1111(b) Election

Non-recourse debt is debt that is secured only by property and not by the debtor's personal promise to pay. In essence, the creditor has agreed to look only to the property for payment and has waived the right to recover a deficiency judgment against the borrower if the collateral is insufficient to satisfy the debt. Non-recourse debt is commonly used in large business transactions, and in some states certain kinds of consumer debts are statutorily non-recourse. It is very rare to see consensually non-recourse debts in consumer transactions.

One of the most strategically complex bankruptcy provisions is contained in Section 1111 of the Bankruptcy Code.

Section 1111(b)(1) of the Bankruptcy Code automatically turns non-recourse debt into recourse debt in Chapter 11 if the debtor is keeping the collateral, unless the debtor makes the 1111(b)(2) election. Thus, even though the loan is non-recourse, if the debtor proposes to strip the claim down under Section 506(a), the nonrecourse creditor gets an unsecured claim for the deficiency (unless the creditor makes the 1111(b)(2) election, discussed below). On the other hand, if the debtor proposes to sell the collateral, the creditor must live with the non-recourse deal that was originally made.

Section 1111(b)(2) of the Bankruptcy Code allows a secured creditor to elect to be treated as **fully secured** by giving up its Section 506(a) unsecured deficiency claim. However, two types of creditors cannot elect under Section 1111(b)(2): (1) a secured creditor whose lien is of inconsequential value (junior lienholder who has very little or no equity in the property, for example), and (2) a recourse creditor whose collateral is being sold under Section 363 or in the plan. There is no reason for recourse creditors to make the election if their property is being sold, since they can credit bid at the sale up to the full amount of the debt. *See* 11 U.S.C. § 363(k). Recourse creditors who elect under 1111(b)(2) when property is being sold would be giving up their deficiency claims without receiving any economic benefit in return.

At first blush, the creditor's ability to prevent the debtor from stripping down a secured claim by making the 1111(b)(2) election would seem like a tremendous secured creditor benefit, but as we will see creditors who make the 1111(b)(2) election do not really have fully secured claims. Under the cramdown rules, these creditors are not entitled to full payment in present value terms. Except in unusual situations where the election may provide a strategic benefit due to the language used in the proposed plan of reorganization, or where the creditor expects the debtor to default after confirmation, undersecured creditors will be better off not making the 1111(b)(2) election.

13.8. Cases on Classifying Claims in Chapter 11 Reorganizations

13.8.1. IN RE US TRUCK CO., 800 F.2d 581 (6th Cir. 1986)

The Teamsters Negotiating Committee (the Teamsters Committee), a creditor of [Chapter 11 debtor] U.S. Truck —appeals the District Court's order confirming U.S. Truck's Fifth Amended Plan of Reorganization. The District Court held that the requirements of section 1129 had been satisfied. We agree.

After filing its petition for relief under Chapter 11, U.S. Truck rejected the collective bargaining agreement [with the Union]. New agreements have been negotiated to the satisfaction of each participating local union. Such agreements have been implemented over the lone dissent of the Teamsters Joint Area Rider Committee. [After rejection] U.S. Truck was able to record monthly profits in the range of $125,000 to $250,000. These new agreements achieved such results by reducing wages and requiring employees to buy their own trucking equipment, which the employees then leased to the company.

The Teamsters Committee's first objection is that the plan does not meet the requirement that at least one class of impaired claims accept the plan, see 11 U.S.C. § 1129(a)(10), because U.S. Truck impermissibly gerrymandered the classes in order to neutralize the Teamsters Committee's dissenting vote. The Teamsters Committee argues that Class XI should have included Class IX [the Teamster's class], and hence was an improperly constructed class.

The issue raised by the Teamsters Committee's challenge is under what circumstances does the Bankruptcy Code permit a debtor to keep a creditor out of a class of impaired claims which are of a similar legal nature as those of the "isolated" creditor. The District Court held that the Code permits such action here because of the following circumstances: (1) the employees represented by the Teamsters Committee have a unique continued interest in the ongoing business of the debtor; (2) the mechanics of the Teamsters Committee's claim differ substantially from those of the Class XI claims; and (3) the Teamsters Committee's claim is likely to become part of the agenda of future collective bargaining sessions between the union and the reorganized company. Thus, according to the court, the interests of the Teamsters Committee are substantially dissimilar from those of the creditors in Class XI. Congress has sent mixed signals on the issue that we must decide. Our starting point is 11 U.S.C. § 1122. The statute, by its express language, only addresses the problem of dissimilar claims being included in the same class. It does not address the correlative problem — the one we face here — of similar claims being put in different classes. Some courts have seized upon this omission, and have held that the Code does not require a debtor to put similar claims in the same class.

U.S. Truck is using its classification powers to segregate dissenting (impaired) creditors from assenting (impaired) creditors (by putting the dissenters into a class or classes by themselves) and, thus, it is assured that at least one class of impaired creditors will vote for the plan and make it eligible for cram down consideration by the court. We agree with the Teamsters Committee that there must be some limit on a debtor's power to classify creditors in such a manner. The potential for abuse would be significant otherwise. Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.

The District Court noted three important ways in which the interests of the Teamsters Committee differ substantially from those of the other impaired creditors. Because of these differences, the Teamsters Committee has a different stake in the future viability of the reorganized company and has alternative means at its disposal for protecting its claim. The Teamsters Committee's claim is connected with the collective bargaining process. In the words of the Committee's counsel, the union employees have a "virtually unique interest." These differences put the Teamsters Committee's claim in a different posture than the Class XI claims. The Teamsters Committee may choose to reject the plan not because the plan is less than optimal to it as a creditor, but because the Teamsters Committee has a noncreditor interest — e.g., rejection will benefit its members in the ongoing employment relationship. Although the Teamsters Committee certainly is not intimately connected with the debtor, to allow the Committee to vote with the other impaired creditors would be to allow it to prevent a court from considering confirmation of a plan that a significant group of creditors with similar interests have accepted. Permitting separate classification of the Teamsters Committee's claim does not automatically result in adoption of the plan. The Teamsters Committee is still protected by the provisions of subsections (a) and (b), particularly the requirements of subsection (b) that the plan not discriminate unfairly and that it be

fair and equitable with respect to the Teamsters Committee's claim. In fact, the Teamsters Committee invokes those requirements, but as we note in the following sections, the plan does not violate them.

The District Court's judgment is affirmed.

13.8.2. IN RE BERNHARD STEINER PIANOS USA, INC., 292 B.R. 109 (Bankr. N.D. Tex. 2002)

This opinion addresses [an] issue which appears frequently in contested confirmation hearings: classification of claims. Although this case is not of national importance, it is very important to the parties involved.

Bernhard Steiner Pianos was established in Europe in 1886. In 1903, the company moved operations to South Africa. Bernhard Steiner Pianos was a part of the Kahn Pianos Group, a family business owned by the Kahn family. The Kahn family enjoys an international reputation in the piano industry, with Ivan Kahn being the fourth generation of piano makers in the family.

In 1976, Ivan Kahn and members of his family relocated to the United States and established Bernhard Steiner Pianos USA, Inc. ("Debtor") in North Dallas. The company deals in the sale and service of new and used pianos of all descriptions. The company sells new pianos, consigns used pianos, and repairs and refurbishes pianos. By 2001, annual sales had reached over $3.3 million.

Unfortunately, the Kahn family also entered into other areas of commerce in Africa. Ivan Kahn's father and mother contracted with the Nigerian government relating to certain construction. The Kahn family was to provide services and the Nigerian government would then submit payment for those services. Ivan Kahn was told that some $30 million had been set aside for payment of his family's debt. The Kahn family eventually depleted their funds in this pursuit. Mr. Kahn began assisting his family in recovering the Nigerian funds through his financial support. Kahn eventually depleted his own funds.

In order to free up some capital to pursue the Nigerian funds, the Debtor began to finance some of its pianos. The Debtor found financing through the Objecting Creditors, who provided pianos to the company on a floor plan basis, i.e., the pianos were brought into the store and once a piano was sold, the funds received were used to pay the floor planner for that particular piano. Kahn provided individual guarantees to these lenders.

In a self-described "misguided" attempt to aid his family, Kahn began borrowing funds from the Debtor without repaying on a timely basis, if at all. To further compound the situation, the events of September 11, 2001 were far-reaching and even impacted negatively a piano store in Dallas, Texas. After the terrorist attacks, piano sales fell dramatically for Mr. Kahn. In late 2001 and early 2002, sales were also dismal. Due to the Debtor's cash crunch, funds were not turned over to the Objecting Creditors providing the floor plan financing. The collateral was exceeded by the debt owed to those entities. Debtor, and Kahn, found themselves out of trust with the Objecting Creditors.

Debtor filed this bankruptcy proceeding on March 14, 2002. Debtor remained open for business during the pendency of this bankruptcy. Early in the case, the Objecting Creditors obtained relief from the automatic stay, and repossessed their remaining collateral.

During this bankruptcy case, Debtor entered into a Court-approved agreement with a third party whereby the third party would provide pianos to Debtor and would also pay for the cost of operations for a 90 day period. In return, Debtor and the third party split the profits from the sale. During this 90 day period, Debtor sold $1 million worth of pianos and netted $45,000. Thereafter, Debtor entered into another Court-approved agreement with another third party who presently provides pianos to Debtor for sale.

Debtor filed its Debtor's Plan of Reorganization dated September 13, 2002 (the "Plan"). The Plan contemplates repayment of Debtor's creditors on a 100% basis. Kahn testified that in order for Debtor to repay its creditors, Debtor must maintain a successful operation. Kahn further testified that Debtor's ability to continue successfully in business will require that the Debtor attract good consignment pianos; the sale of new pianos alone will not suffice.

Typically, consignment pianos come from individual owners. Most of the consignment business is by word of mouth. In the piano industry, if a consignee gets the reputation that it is unwilling or unable to pay consignors, the consignee won't be able to attract good consignment pianos. Kahn testified that it would be very difficult to supplement any lost consignment income through other operations. Kahn testified that the quicker the Debtor repays the consignment class, the quicker they will get new consignment pianos.

Kahn testified that he will remain the president of the company after confirmation. Largely speaking, Mr. Kahn is all that is left of the Debtor. The company's only tangible assets are some desks and some old wood. At the confirmation hearing, the parties were complimentary of Mr. Kahn's heroic efforts at keeping the Debtor in operation. Through his management during the pendency of the bankruptcy, Kahn singlehandedly managed to keep the Debtor's doors open. The Bernhard Steiner Pianos name is closely associated with Kahn and the Kahn family in the minds of the piano-buying public. The public identifies the Debtor and Mr. Kahn as one and the same. The Plan was ultimately approved by all the impaired classes except for Class 6, of which the Objecting Creditors, the floor plan lenders, are members.

The Plan separately classifies creditors whose claims arose from consigned goods and general unsecured claims, including the claims of the floor plan Objecting Creditors.

The consignment creditors, Class 4, will be repaid over a term of 10 months beginning on the effective date of the plan. The floor plan lenders are part of the allowed general unsecured class, Class 6. Under the Plan, as originally drafted, their scheduled payments begin after full payment to Class 4, approximately one year after the effective date. Under an agreed modification made in Court after the effective date, the Class 6 creditors will also begin to receive a portion of excess cash flow. Based on the record, the excess cash flow payments should begin before the Class 4 consignment claims are paid in full. Despite the favorable change in the payment schedule, the Objecting Creditors still object and argue that both Class 4 and Class 6 should be placed in the same class.

All unsecured claims outstanding as of the commencement of the case, and claims arising from the rejection of executory contracts or unexpired leases, may be classified together as general unsecured claims. However, the Code does not require that all such claims be placed within a

single class. See also *In re U.S. Truck Co., Inc.*, 800 F.2d 581 (6th Cir.1986). Separate classification of some unsecured claims is allowed if the classification scheme is reasonable.

The Fifth Circuit has taught that, as a general premise, substantially similar claims, or those which share common priority and rights against the debtor's estate, should be placed in the same class. *Matter of Greystone*, 995 F.2d 1274 (5th Cir. 1992). Substantially similar claims are not permitted to be separately classified "in order to gerrymander an affirmative vote on a reorganization plan."

Nevertheless, in this Circuit, separate classification is permitted for "good business reasons." In the present case, the Debtor has met the good business reason test. Selling consigned pianos has historically been an important part of the Debtor's business and is contemplated to be an integral part of the Debtor's future. Debtor presented evidence, which was not rebutted, that its consignment business had suffered significantly since word had leaked out that Debtor did not remit the proceeds from the sale of consigned pianos. Kahn testified that the consignment market is local and small, and adverse local community opinion affected whether pianos would be consigned to the Debtor or to its competitors. Kahn also testified that competitors were informing potential consignors that Debtor had failed to remit the sale proceeds to its past consignors. The undisputed testimony is that the Class 4 consignment creditors were separately classified so as to accelerate repayment to them so Debtor could begin expeditiously to repair its tarnished consignment name in a small market. Improving the consignment public's perception of this Debtor and restoring trust in the Debtor among potential consignors as soon as possible is important to the success of the reorganization overall.

No evidence of gerrymandering was offered at the confirmation hearing. Debtor's principal, Mr. Kahn, testified that the development of future consignment business was necessary to its successful reorganization and accordingly, for the repayment of its creditors. Further, the Plan, on its face, treats the consignment class and the general unsecured class differently. The Debtor has presented a good business reason for the separate classification and treatment of consignment creditors in Class 4 from the claims of the general unsecured creditors; therefore, the Court overrules the classification objection.

13.8.3. PHOENIX MUT. LIFE v. GREYSTONE III JOINT VENTURE, 995 F.2d 1274 (5th Cir. 1991)

EDITH H. JONES, Circuit Judge:

This appeal pits a debtor whose only significant asset is an office building in the troubled Austin, Texas real estate market against a lender who possesses a multi-million dollar lien on the property. After obtaining bankruptcy relief under Chapter 11, Greystone III proposed a "cramdown" plan of reorganization, hoping to force a writedown of over $3,000,000 on the secured lender's note and to retain possession and full ownership of the property. Over the secured lender's strenuous objections, the bankruptcy court confirmed the debtor's plan.

Appellant Phoenix Mutual Life Insurance Corporation lent $8,800,000, evidenced by a non-recourse promissory note secured by a first lien, to Greystone to purchase the venture's office building. When Greystone defaulted on the loan, missing four payments, Phoenix posted the

property for foreclosure. Greystone retaliated by filing a Chapter 11 bankruptcy reorganization petition.

At the date of bankruptcy Greystone owed Phoenix approximately $9,325,000, trade creditors approximately $10,000, and taxing authorities approximately $145,000. The bankruptcy court valued Phoenix's secured claim at $5,825,000, the appraised value of the office building, leaving Phoenix an unsecured deficiency of approximately $3,500,000 —the difference between the aggregate owed Phoenix and its secured claim.

As filed, Greystone's Plan of Reorganization, the confirmation of which is challenged in this appeal, separately classified the Code-created unsecured deficiency claim of Phoenix Mutual and the unsecured claims of the trade creditors. The Plan proposed to pay Phoenix and the trade creditors slightly less than four cents on the dollar for their unsecured claims, **but it also provided that Greystone's general partner would satisfy the balance of the trade creditors' claims after confirmation** of the Plan.

In a separate class, the Plan further provided for security deposit "claims" held by existing tenants of the office building. These claimants were promised, notwithstanding the debtor's eventual assumption of their leases, 11 U.S.C. § 365, 25% of their deposits upon approval of the Plan and 50% of their deposits at the expiration of their respective leases. The Plan stipulated that the general partner would "retain its legal obligations and ... pay the [tenant] ... creditors the balance of their claims upon confirmation."

Finally, Greystone's Plan contemplated a $500,000 capital infusion by the debtor's partners, for which they would reacquire 100% of the equity interest in the reorganized Greystone.

Unsurprisingly, Phoenix rejected this Plan, while the trade creditors and the class of holders of tenant security deposits voted to accept it. On January 27, 1989, the bankruptcy court held a confirmation hearing at which the Debtor orally modified its Plan to **delete the statements that the general partner would pay the balance of trade debt and tenant security deposit claims after confirmation**. A Phoenix representative testified that the insurance company was willing to fund its own plan of reorganization by paying off all unsecured creditors in cash in full after confirmation. The bankruptcy court refused to consider this proposal and then confirmed Greystone's modified Plan. The district court upheld the confirmation.

Phoenix attacks Greystone's classification of its unsecured deficiency claim in a separate class from that of the other unsecured claims against the debtor. This issue benefits from some background explanation.

[The court then discusses the requirement that one impaired class of creditors vote for the plan under § 1129(a)(10)]. Classification of claims thus affects the integrity of the voting process, for, if claims could be arbitrarily placed in separate classes, it would almost always be possible for the debtor to manipulate "acceptance" by artful classification.

In this case, Greystone's plan classified the Phoenix claim in separate secured and unsecured classes, a dual status afforded by 11 U.S.C. § 1111(b) despite the nonrecourse nature of Phoenix's debt. Because of Phoenix's opposition to a reorganization, Greystone knew that its only hope for confirmation lay in the Bankruptcy Code's cramdown provision. Procedurally, Greystone faced a dilemma in deciding how to obtain the approval of its cramdown plan by at least one class of "impaired" claims, as the Code requires. Greystone anticipated an adverse vote of Phoenix's

secured claim. If the Phoenix $3.5 million unsecured deficiency claim shared the same class as Greystone's other unsecured trade claims, it would swamp their $10,000 value in voting against confirmation. The only other arguably impaired class consisted of tenant security deposit claims, which, the bankruptcy court found, were not impaired at all.

Greystone surmounted the hurdle by classifying Phoenix's unsecured deficiency claim separately from the trade claims, although both classes were to be treated alike under the plan and would receive a cash payment equal to 3.42% of each creditor's claim. Greystone then achieved the required favorable vote of the trade claims class.

Phoenix contends that Greystone misapplied § 1122 by classifying its unsecured claim separately from those of trade creditors. The lower courts rejected Phoenix's argument in three steps. First, they held that § 1122 of the Code does not unambiguously prevent classification of like claims in separate classes. The only question is what types of class differentiations among like claims are acceptable. Second, Greystone's unsecured deficiency claim is "legally different" from that of the trade claims because it arises statutorily, pursuant to § 1111(b). Third, "good business reasons" justify the separate classification of these unsecured claims. We must address each of these arguments.

We observe from this language that the lower courts' suggestion that § 1122 does not prevent classification of like claims in separate classes is oversimplified. It is true that § 1122(a) in terms only governs permissible inclusions of claims in a class rather requiring that all similar claims be grouped together. One cannot conclude categorically that § 1122(a) prohibits the formation of different classes from similar types of claims. But if § 1122(a) is wholly permissive regarding the creation of such classes, there would be no need for § 1122(b) specifically to authorize a class of smaller unsecured claims, a common feature of plans in reorganization cases past and present. The broad interpretation of § 1122(a) adopted by the lower courts would render § 1122(b) superfluous, a result that is anathema to elementary principles of statutory construction.

Section 1122 consequently must contemplate some limits on classification of claims of similar priority. A fair reading of both subsections suggests that ordinarily "substantially similar claims," those which share common priority and rights against the debtor's estate, should be placed in the same class. Section 1122(b) expressly creates one exception to this rule by permitting small unsecured claims to be classified separately from their larger counterparts if the court so approves for administrative convenience. The lower courts acknowledged the force of this narrow rather than totally permissive construction of § 1122 by going on to justify Greystone's segregation of the Phoenix claim. Put otherwise, the lower courts essentially found that Phoenix's unsecured deficiency claim is not "substantially similar" to those of the trade creditors.

Those courts did not, however, adhere to the one clear rule that emerges from otherwise muddled case law on § 1122 claims classification: **thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.** We agree with this rule, and if Greystone's proffered "reasons" for separately classifying the Phoenix deficiency claim simply mask the intent to gerrymander the voting process, that classification scheme should not have been approved.

Greystone contends that the "legal difference" between Phoenix's deficiency claim and the trade creditors' claims is sufficient to sustain its classification scheme. The alleged distinction between the legal attributes of the unsecured claims is that under state law Phoenix has no recourse

against the debtor personally. However, state law is irrelevant where, as here, the Code has eliminated the legal distinction between non-recourse deficiency claims and other unsecured claims.

The purpose of § 1111(b) is to provide an undersecured creditor an election with respect to the treatment of its deficiency claim. Generally, the creditor may elect recourse status and obtain the right to vote in the unsecured class, or it may elect to forego recourse to gain an allowed secured claim for the entire amount of the debt. If separate classification of unsecured deficiency claims arising from non-recourse debt were permitted solely on the ground that the claim is non-recourse under state law, the right to vote in the unsecured class would be meaningless. Plan proponents could effectively disenfranchise the holders of such claims by placing them in a separate class and confirming the plan over their objection by cramdown. With its unsecured voting rights effectively eliminated, the electing creditor's ability to negotiate a satisfactory settlement of either its secured or unsecured claims would be seriously undercut. It seems likely that the creditor would often have to "elect" to take an allowed secured claim under § 1111(b)(2) in the hope that the value of the collateral would increase after the case is closed. Thus, the election under § 1111(b) would be essentially meaningless. We believe Congress did not intend this result.

As the bankruptcy court viewed this issue, the debtor's ability to achieve a cramdown plan should be preferred over the creditor's § 1111(b) election rights because of the Code's policy of facilitating reorganization. The bankruptcy court resorted to policy considerations because it believed Congress did not foresee the potential impact of an electing creditor's deficiency claim on the debtor's aspiration to cramdown a plan. We disagree with this approach for three reasons. First, it results here in violating § 1122, by gerrymandering the plan vote, for the sake of allegedly effectuating a § 1129(b) cramdown. "Policy" considerations do not justify preferring one section of the Code, much less elevating its implicit "policies" over other sections, where the statutory language draws no such distinctions. Second, as shown, it virtually eliminates the § 1111(b) election for secured creditors in this type of case. Third, the bankruptcy court's concern for the viability of cramdown plans is overstated. If Phoenix's unsecured claim were lower and the trade debt were higher, or if there were other impaired classes that favored the plan, a cramdown plan would be more realistic. That Greystone's cramdown plan may not succeed on the facts before us does not disprove the utility of the cramdown provision. The state law distinction between Code-created unsecured deficiency claims and other unsecured claims does not alone warrant separate classification.

Greystone next argues that separate classification was justified for "good business reasons." The bankruptcy court found that the debtor "need[s] trade to maintain good will for future operations." The court further reasoned:

> [I]f the expectation of trade creditors is frustrated ... [they] have little recourse but to refrain from doing business with the enterprise. The resulting negative reputation quickly spreads in the trade community, making it difficult to obtain services in the future on any but the most onerous terms.

Greystone argues that the "realities of business" more than justify separate classification of the trade debt from Phoenix's deficiency claim. This argument is specious, for it fails to distinguish between the classification of claims and the treatment of claims. Greystone's justification for

separate classification of the trade claims might be valid if the trade creditors were to receive different treatment from Phoenix. Indeed, Greystone initially created a separate class of unsecured creditors that could be wooed to vote for the plan by the promise to pay their remaining claims in full outside the plan. Greystone then changed course and eliminated its promise. Because there is no separate treatment of the trade creditors in this case, we reject Greystone's "realities of business" argument.

Even if Greystone's Plan had treated the trade creditors differently from Phoenix, the classification scheme here is still improper. At the confirmation hearing, none of the Debtor's witnesses offered any reason for classifying the trade debt separately from Phoenix's unsecured deficiency claim. **There is no evidence in the record of a limited market in Austin for trade goods and services**. Nor is there any evidence that Greystone would be unable to obtain any of the trade services if the trade creditors did not receive preferential treatment under the Plan. Thus, the bankruptcy court's finding that there were good business reasons for separate classification is without support in the record and must be set aside as clearly erroneous.

Phoenix's unsecured deficiency claim approximates $3,500,000, while the claims of the unsecured trade creditors who voted to accept the Plan total less than $10,000. Greystone's classification scheme, which effectively disenfranchised Phoenix's Code-created deficiency claim, is sanctioned neither by the Code nor by caselaw. The lower courts erred in approving it.

13.8.4. IN RE SM 104 LIMITED, 160 B.R. 202 (Bankr. S.D. Fla. 1993)

The Debtor is a limited partnership which owns and operates an office complex called Cypress Creek Executive Court in Fort Lauderdale, Florida. The office complex is situated on land leased from the City of Fort Lauderdale. The Debtor acquired the leasehold in 1984 and, subsequently, built the office complex on it. Construction financing was provided by South Florida Savings Bank.

On September 18, 1992, the Debtor filed a proposed plan of reorganization. The Debtor's plan divides the claims against the Debtor into 7 classes. Class 1 is EquiVest's disputed nonrecourse secured claim. Class 2 is the claim of Capital Bank, which has a nonrecourse junior mortgage on the Cypress Creek property as a result of a loan it made to SM 108. Capital Bank's claim and mortgage is worthless, because the Cypress Creek property is fully encumbered by EquiVest's senior claim, leaving no equity for Capital Bank's mortgage, and Capital Bank's loan is nonrecourse. Class 3 is EquiVest's unsecured deficiency claim. Class 4 is the claim of Fort Lauderdale for rent arrearages and the past-due 1991 property taxes. That claim has been paid in full. Class 5 is the claims of the Debtor's trade creditors, totaling approximately $175,000. Class 6 is the unsecured claims of Murphy. Finally, Class 7 is the interests of the Debtor's equity security holders.

Basically, the Debtor's plan proposes to pay EquiVest's secured claim over 10 years, with interest at 8%, based on a twenty year amortization. The plan also proposes to pay Capital Bank's claim, EquiVest's unsecured deficiency claim, and the general unsecured claims an equal dividend on the effective date, with any balance owed to be paid in equal quarterly installments over the next two years. The plan does not provide for Class 4, which has already been paid in full. Furthermore, the plan waives the Class 6 inside claims. Finally, the plan proposes to wipe out, in

effect, the existing equity interests. Under the plan, the equity interests in the reorganized Debtor will go to Murphy in exchange for a one-time payment of $200,000 from Murphy to the Debtor on the effective date of the plan. Murphy intends to distribute the new equity interests to the old equity holders.

Class 1, EquiVest's secured claim, voted to reject the plan. Class 2, the claim of Capital Bank, originally voted to reject the plan, but, subsequent to the ballot deadline, was permitted to change its ballot to accept the plan. Class 3, EquiVest's unsecured deficiency claim, voted to reject the plan. Class 4, the City of Fort Lauderdale, is unimpaired by the plan, and, therefore, does not vote. Class 5, the trade creditors' claims, voted to accept the plan. Classes 6 and 7, the claims of insider creditors and interests of existing equity holders, are wiped out by the plan and thus are deemed to reject it. See 11 U.S.C. § 1126(g).

On March 1, 1993, EquiVest filed its objections to the confirmation of the Debtor's plan.

There is no doubt that EquiVest's claim is undersecured. EquiVest's total claim is approximately $5.5 million. The parties agree that the value of EquiVest's collateral, the Cypress Creek property, does not exceed $2.7 million. Section 506(a) provides that an undersecured claim is to be bifurcated into two claims, secured and unsecured. In determining the amount of an undersecured creditor's secured claim under § 506(a), property is to be valued "in light of the purpose of the valuation and of the proposed disposition or use of such property." 11 U.S.C. § 506(a). Where a debtor's plan proposes to retain and use the property, it is appropriate to value the property at its fair market value.

In this case, we have the usual battle of the appraisers. EquiVest's appraiser, John Danner, values the property at $2.7 million. The Debtor's appraiser, Fred Roe, values the property at $2.15 million. [After evaluating the appraisals, the Court concludes that] the value of EquiVest's collateral is $2.27 million. Under § 506(a), EquiVest's secured claim is fixed at that amount. EquiVest's unsecured claim is equal to the difference between its total claim of approximately $5.5 million and its secured claim, $3.23 million.

EquiVest objects to the classification of its unsecured deficiency claim separately from other unsecured claims. EquiVest's argument in this regard is erroneous.

Section 1129(a)(10) of the Bankruptcy Code provides that before a plan can be crammed down over the objections of a creditor class, at least one impaired class of creditor claims must vote to accept the plan, without regard to any insider votes. 11 U.S.C. § 1129(a)(10). Thus, the Debtor, to get its plan confirmed over EquiVest's objections, must come up with one impaired creditor class that accepts the plan, without regard to any insider votes in that class.

The Debtor has placed EquiVest's § 1111(b) — created deficiency claim in a separate class by itself, Class 3. This court has previously held EquiVest's unsecured claim is $3.23 million. The other unsecured creditors' claims are placed by the Debtor's plan in Class 5, and total $175,000. Given the size of EquiVest's § 1111(b) unsecured deficiency claim relative to the other unsecured claims and EquiVest's opposition to the plan, it is obvious the reason the Debtor seeks to separately classify EquiVest's § 1111(b) deficiency claim from the claims of other unsecured creditors is to satisfy the requirements of § 1129(a)(10); i.e., to get one impaired class to accept the plan.

EquiVest claims that the Debtor's apparently manipulative motive is improper, and that EquiVest's unsecured deficiency claim should be placed in the same class as the claims of the

general unsecured creditors. If the court accepts EquiVest's argument that it should be classified with the other general unsecured creditors in a single class and EquiVest's argument that the Class 5 unsecured creditors were the only impaired class to accept the plan, such a joint classification would be the death knell for the Debtor's plan because the Debtor could no longer satisfy the requirements of § 1129(a)(10). The Debtor also argues that such separate classification, whether or not done solely to gerrymander to create an accepting impaired class, is perfectly consistent with the Bankruptcy Code.

In general, the proponent of a Chapter 11 plan has broad discretion to classify claims and interests in the plan according to the particular facts and circumstances of each case. Section 1122(a) expressly provides that only substantially similar claims may be placed in the same class. It does not expressly require that all substantially similar claims be placed in the same class, nor does it expressly prohibit substantially similar claims from being classified separately. Nevertheless, many courts, including five circuit courts of appeal, while recognizing that § 1122 does not explicitly forbid a plan proponent from placing similar claims in separate classes, have imposed significant limits on the ability of a plan proponent to do so. The majority of lower courts have followed suit. In *Greystone*, the Fifth Circuit held that "one clear rule" has emerged from the otherwise muddled § 1122 case law: "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."

However, while *Greystone* and the other cases have paid lip service to principles of statutory construction and the language of § 1122, they have turned more on notions of basic fairness and good faith. Indeed, most courts seem to base their rulings less on the language of § 1122 than on their view that separate classification is usually done to manipulate the voting to insure that at least one impaired class of creditors accepts the plan, and thus that the plan meets the requirements of § 1129(a)(10). Courts subscribing to this view have rejected any plan where the classification scheme "is designed to manipulate class voting, or violates basic priority rights."

Obviously, one premise for the rulings in Greystone [and other cases following it] has been that unsecured deficiency claims created by § 1111(b) are substantially similar to general unsecured claims. Indeed, if the claims are not substantially similar, § 1122(a) would bar them from being put in the same class. However, a few lower courts have rejected this conclusion and held that unsecured deficiency claims created by § 1111(b) are not substantially similar to other unsecured claims, and thus that separate classification of those claims is not only permissible, but mandatory. These latter courts rely on two lines of reasoning to support their conclusion. First, some of these courts believe that general unsecured claims and unsecured deficiency claims created by § 1111(b) are legally distinct because the former are recourse claims cognizable under state law, while the latter exist only within the Chapter 11 bankruptcy case and are not cognizable under state law. The circuit courts have largely rejected this argument, holding that § 1111(b) has largely eliminated the legal distinction between non-recourse deficiency claims for purposes of Chapter 11.

In addition, the minority of courts supporting the proposition that the separate classification of unsecured deficiency claims created by § 1111(b) is either proper or required often argue that separate classification is permissible on the grounds that the vote of such claims will be uniquely affected by the plan's proposed treatment of the secured claim held by the creditor. Thus, for example, the court in *Aztec* [107 B.R. 585 (Bankr. MD Tenn. 1989)] reasoned that the undersecured mortgagee would have "every incentive to vote its large deficiency claim to affect

the treatment of its secured claim by defeating confirmation of any plan" if classified with other unsecured creditors. *Aztec*, at 587. Such a rationale is highly persuasive when viewed in light of the logic underlying § 1129(a)(10). Section 1129(a)(10) was intended not to give the real estate lobby a veto power, but merely to require "some indicia of creditor support" for confirmation of a proposed Chapter 11 plan."

[T]his court believes that the lines of reasoning articulated by the circuit courts and the majority of district and bankruptcy courts have missed the forests for the trees. Section 1122(a) allows joint classification of claims only if the claims are substantially similar in terms of their legal rights. There are, however, significant differences between the legal rights of a general unsecured claim and an unsecured deficiency claim created for the nonrecourse lender by § 1111(b). Thus, an unsecured deficiency claim created by § 1111(b) is not substantially similar to general unsecured claims, and, under § 1122(a), the two types of claims **cannot** be classified together.

One area in which the distinction between the rights of holders of general unsecured claims and the rights of § 1111(b) deficiency claimants can be seen clearly is in the application of the "best interests" test of § 1129(a)(7). [T]he majority in a class can never force the minority in that class to take less in present value terms than the minority would receive in a Chapter 7 liquidation case involving the debtor.

The application of this standard to a class consisting of both general unsecured claims and § 1111(b) deficiency claims can lead to anomalous results. A simple example shows why. Suppose that an unsecured deficiency claim created by § 1111(b) is placed in the same class as the general unsecured claims, and that the plan provides for that class to receive a 25% payment of claims on the effective date of the plan. Suppose further that, in a Chapter 7 liquidation, the holders of general unsecured claims would be paid a 35% dividend. The plan would fail the best interests of the creditors test as to the general unsecured creditors, and the plan could not be confirmed unless each general unsecured claim voted for the plan. This would be true even if a majority in number and two-thirds in amount of the claims in the class that voted on the plan voted to accept. On the other hand, the plan would propose to give the unsecured deficiency claim created by § 1111(b) more than it would receive in a hypothetical Chapter 7 liquidation: in a Chapter 7 case, the unsecured deficiency claim created by § 1111(b) would not exist and would not be paid at all.

All that is ever required to satisfy the best interests test as to a § 1111(b) nonrecourse deficiency claim is for the claimholder to receive the present value of the collateral. Nevertheless, as long as joint classification is utilized, the holder of a § 1111(b) deficiency claim can hold out for a dividend equal to what the general unsecured claims are being paid to satisfy the best interests of the creditors test as to such creditors, even though the undersecured nonrecourse claim is never entitled to any payment in a Chapter 7 case for the amount by which the value of its collateral is less than it is owed. This is because § 1123(a)(4) requires a plan to provide for the same treatment of all claims in a class, unless the holder of a claim agrees to less favorable treatment. 11 U.S.C. § 1123(a)(4). Thus, in the hypothetical above, if the plan were amended to satisfy the best interests of the creditors test by giving the holders of general unsecured claims a 35% dividend, the holder of the § 1111(b) nonrecourse deficiency claim could, as long as the claims are jointly classified, insist on the same 35% dividend, or block confirmation of the plan. It would be hard to believe that the drafters of the Bankruptcy Code intended such an absurd result.

There are other significant disparities between the legal rights of the holder of a general unsecured claim and the holder of a § 1111(b) nonrecourse deficiency claim. For example, if the debtor is a partnership, the general partners are liable for the debts of the partnership in the event the case converts to one under Chapter 7. See 11 U.S.C. § 723. If the Chapter 11 case shows signs of possible failure, the general unsecured creditors could seek equitable relief to prevent dissipation of the assets of the general partners pending resolution of the Chapter 11 case. It is unlikely that the holder of a § 1111(b) nonrecourse deficiency claim could pursue such relief, since the nonrecourse lender is confined to its collateral as a source of payment in Chapter 7. It has no deficiency claim against either the estate or the general partners.

It is clear that the legal rights of creditors holding unsecured deficiency claims created by § 1111(b) and general unsecured creditors are, for classification purposes, substantially dissimilar. Therefore, separate classification of unsecured deficiency claims created by § 1111(b) and general unsecured claims is not only permissible, but mandatory. Thus, this court rules that the Debtor's separate classification of EquiVest's Class 3 unsecured deficiency claim and the claims of the Class 5 general unsecured creditors is permissible. Indeed, such separate classification is required by § 1122(a).

13.8.5. Practice Problems: Classification, Voting and Impairment

Answer the following questions:

Problem 1. Debtors have five classes of creditors who have voted on a Chapter 11 plan of reorganization. Determine which of the classes have accepted and which have rejected the plan.

	Class 1	Class 2	Class 3	Class 4	Class 5
Total Creditors in Class	100	2,000	12	150,000	352,687
Total Claims in Class	$ 1,000,000	$ 3,000,000	$ 450,000	$ 25,000,258	$ 12,569,854
Creditors Voting Yes	31	700	5	90,000	152,365
Claims Voting Yes	$ 600,000	$ 1,525,000	$ 250,000	$ 14,256,897	$ 4,000,365
Creditors Voting No	29	700	4	45,000	152,536
Claims Voting No	$ 300,000	$ 1,016,666	$ 100,000	$ 7,425,698	$ 1,998,562

Problem 2. Debtor owes a secured loan that matures next year. Debtor has proposed a Chapter 11 plan that pays the claim in cash in full on the effective date of the plan. Is the creditor entitled to vote on the plan? 11 U.S.C. §§ 1124, 1126(f).

Problem 3. Debtor owes $1 million on a loan secured by its sole asset – an office building. Debtor missed 5 prepetition monthly payments and 3 post-petition monthly payments. Debtor proposes a plan to pay the 8 months of arrearages over the 10 year term of the plan with post-petition interest at the *Till* rate (prime +2%), together with the regular installments coming due in the future. Is the creditor impaired? 11 U.S.C. § 1124.

Problem 4. Debtor was forced to close its store for 10 days prepetition when the debtor ran out of funds to pay employees. Debtor's lease contains a "going dark" clause that provides that the tenant who ceases to operate the store at any time during the shopping center's business hours

is in default. Debtor wants to re-open the store, and has proposed to pay all back rent in cash and reopen. Is the landlord entitled to vote against the plan? To avoid the landlord's vote, must Debtor compensate the landlord for lost percentage rent during the days that the store was closed? 11 U.S.C. § 1124.

Problem 5. Debtor needs one class of creditors to vote for the plan. 11 U.S.C. § 1129(a)(10). Debtor proposes to separately classify and pay a friendly creditor $99,999.99 on a $100,000 unsecured claim. Does this work? 11 U.S.C. § 1122, 1124.

Problem 6. In order to confirm its plan of reorganization, Debtor must classify the Section 506(a) unsecured portion of its lender's undersecured claim separately from the claims of trade creditors, because the lender will vote no, and the lender's unsecured claim will swamp the claims of the other unsecured creditors who will vote yes. Is Debtor allowed to separately classify the lender's unsecured claim? Does it matter whether the original loan was with recourse or without recourse?

13.9. Confirmation Requirements under 11 U.S.C. § 1129(a)

Section 1129(a) contains a long string of confirmation requirements. With one exception described later, known as the "cramdown," all of the requirements of Section 1129(a) must be met before the bankruptcy court may confirm the plan. The most important requirements are as follows:

(a) The Best Interests of Creditors Test. 11 U.S.C. § 1129(a)(7).

The plan proponent must show that any creditor who did not vote for the plan will receive present value at least equal to the amount they would receive in an instant Chapter 7 liquidation occurring on the date of confirmation.

(b) Acceptance by Every Class. 11 U.S.C. § 1129(a)(8).

Each class must either accept the plan or be unimpaired (and thereby deemed to accept the plan). This is the only Section 1129(a) requirement that is not always required for confirmation. If one or more classes do not accept, the plan may still be confirmed if the plan meets the cramdown requirements of Section 1129(b).

(c) Priority Claim Treatment. 11 U.S.C. § 1129(a)(8).

Unless a particular creditor agrees to accept different treatment, administrative and gap priority claims must be paid in cash and in full (11 U.S.C. § 1129(a)(9)(A)); Tax priority claims must be paid in full with interest over a period not exceeding five years and in a manner not less favorable to the treatment of non-priority claims (1129(a)(9)(C)); and most other priority claims must be paid in cash on the effective date unless the class votes to accept full payments over time with interest.

(d) One Accepting Impaired Class. 11 U.S.C. § 1129(a)(10).

If any class is impaired, at least one impair class votes to accept the plan.

(e) Feasibility. 11 U.S.C. § 1129(a)(11).

The Debtor must show that the plan can be completed without the need for further financial reorganization.

(f) Projected Disposable Income Test for Individual Debtors. 11 U.S.C. § 1129(a)(15).

This is the same test as in Chapter 13 (11 U.S.C. § 1325(b)(2)), except it requires a five year plan even for below median debtors.

13.10. The Cramdown – 11 U.S.C. §1129(b)

A debtor who meets all of the requirements for confirmation except section 1129(a)(8) (the requirement that all classes have accepted the plan), may still be able to confirm the plan under the **cramdown** rules in section 1129(b). Section 1129(b) allows for confirmation over the rejection of one or more class(es) of claims or interests if the plan is fair and equitable and does not discriminate unfairly against the creditors. The discriminate unfairly requirement is not defined in the Bankruptcy Code and is rarely discussed in the case law. The primary focus is on the "fair and equitable requirement" which is defined to include three sets of rules: (1) Section 1129(b)(2)(A) for cramming down secured classes, (2) Section 1129(b)(2)(B) for cramming down unsecured classes, and (3) section 1129(b)(2)(C) for cramming down equity interest classes.

13.10.1. Cramdown of Secured Claims

Secured claims can be restructured under Section 1129(b)(2)(A)(i), the collateral can be sold and the creditor paid the proceeds of sale (with the right to credit bid) under Section 1129(b)(2)(A)(ii), or the plan can provide the secured creditors in the non-accepting class with the "indubitable equivalent" of their claims, under Section 1129(b)(2)(A)(iii). The main focus must be on the restructuring provisions. The creditor must retain its lien, and receive deferred cash payments TOTALLING the allowed amount of the claim, but having a PRESENT VALUE equal to the value of the creditor's interest in the property. Thus, the arithmetic sum of the payments must exceed the total claim, but the present value of the stream need only equal the 506(a) secured claim. To maintain present value, the payment stream must include interest at the "Till" rate on the value of the property, but not on the claim amount. Indeed, the claim amount can be paid without any interest at all, if the present value of the stream will exceed the value of the property.

What is the relationship between the 1111(b)(2) election and the cramdown formula? Suppose the creditor's total claim is $100,000, secured by property worth $60,000. Under Section 506(a), the creditor would have a $60,000 secured claim and a $40,000 unsecured claim. But if the creditor made the 1111(b)(2) election, the creditor would be treated as having a $100,000 secured claim even though the property is worth only $60,000. The debtor would have to make TOTAL payments of $100,000 to the creditor (the amount of the claim), but the present value of the payment stream would have to be only $60,000 (the value of the creditor's lien). If prevailing interest rates are 10%, the debtor could propose to pay $10,000 per year for 10 years, equaling total payments of $100,000. But the discounted present value of those payments would be only $61,445.67. If the creditor makes the 1111(b)(2) election, the debtor may simply propose to pay

the claim without interest (or with below market rate interest if necessary to maintain the present value of the collateral). Under the statutory test, the real value that the creditor receives may be no more than the value of the creditor's lien. The receipt of the total secured claim, without (or with below market) interest, will not generally be of importance to a financially sophisticated creditor. If the debtor makes the proposed payments, the creditor is worse off in real present value terms than if the creditor did not make the election, because the non-electing creditor would receive the same present value of its secured claim, plus would receive some distribution on its unsecured claim. The creditor may receive no "value" to in return for giving up its unsecured claim.

The alternative "indubitable equivalent" provision has come under scrutiny in the "dirt for debt" cases, where a debtor proposes in a plan to paydown the creditor's secured claim by returning a portion of the collateral to the secured creditor, based on the bankruptcy court's valuation of the property. The Ninth Circuit Court of Appeals considers such a plan, and the meaning of "indubitable equivalence," in the *Arnold & Baker* case reprinted below.

13.10.2. Cramdown of Unsecured Claims

The cramdown rule for unsecured creditors is simple: the claims of senior classes must be paid in full with post-confirmation interest, or no junior creditor or equity security classes can receive or retain any property on account of their claims or interests. This is the absolute priority rule, and prevents the equity owners from keeping their interests unless all non-consenting unsecured creditor classes are paid in full. For example, corporate business plans can easily be crammed down on objecting existing shareholders if management is willing to sacrifice the shareholder interests by distributing all of the stock to the creditors.

Like alchemists trying to turn cheap iron into gold, debtors have been searching for a way around the absolute priority rule since its inception. The most promising gambit has been the so called "new value corollary," under which the equity holders would retain their stock or other interests in the reorganized debtor not on account of their prior equity interests but on account of their new contributions of money, property or services under the plan.

In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), a debtor farmer sought to keep the equity in his farm under a plan that did not pay unsecured creditors in full, by giving the estate his employment contract, under which he promised to render his labor to work the farm in return for the new equity. The Supreme Court refused to decide whether a new value corollary exists or not, but ruled that, if it exists, the new value must be "money or money's worth," not the promise of future services.

While not answering the ultimate question of whether the new value corollary exists, the Court in *BofA v. 203 North LaSalle* case reprinted below, made clear that it is, at best, a very narrow exception to the absolute priority rule. The Court left the door open slightly for debtors to maintain their equity interests without paying dissenting creditors in full, but in most cases and for all practical purposes the door will be closed.

13.10.3. Cases on Cramming Down Secured Claims in a Chapter 11 Plan of Reorganization

13.10.3.1. IN RE ARNOLD & BAKER FARMS, 85 F.3d 1415 (9th Cir. 1996)

WILLIAM A. NORRIS, Circuit Judge:

Debtor Arnold and Baker Farms petitioned for relief under Chapter 11 and filed a plan of reorganization which proposed to satisfy the claims of the creditors by transferring real property to them—colloquially known as a "dirt for debt" plan. When Arnold and Baker's largest creditor, the Farmers Home Administration (FmHA), objected to the plan, Arnold and Baker invoked the "cram down" provision of the Bankruptcy Code, 11 U.S.C. § 1129(b). The question presented is whether the plan's proposal to transfer to FmHA a portion of the collateral securing FmHA's claim will provide FmHA with the "indubitable equivalent" of its secured claim, as required by the "cram down" provision. See 11 U.S.C. § 1129(b)(2)(A)(iii).

The debtor Arnold and Baker Farms is an Arizona general partnership. Arnold and Baker purchased 1120 acres in 1975 and an additional 320 acres in 1979. In 1977, the farm began to experience financial difficulties. [The sellers carried back first deeds of trust to secure repayment of the purchase price.]

[FmHA and Western Cotton] financed certain crops for the years 1978 through 1981, and FmHA lent Arnold and Baker sufficient funds to make the annual payments on the installments due to the [sellers] in the years 1979, 1980, and 1983. In return, FmHA held a second deed of trust on Arnold and Baker's real property, and Western Cotton held a third deed of trust.

Arnold and Baker's plan proposed to pay FmHA's $3,837,618 note and Western Cotton's $565,044 note in full. The plan proposed to transfer a proportionate fee simple interest in the 635 acre parcel of real property to FmHA and Western Cotton. FmHA was earmarked to receive 515 acres of real property and Western Cotton was earmarked to receive 77 acres. Arnold and Baker was earmarked to retain ownership of 48 of the 640 acres scheduled for distribution. Arnold and Baker proposed to sell the adjoining 360 acre parcel of real property in order to pay the administrative claims, United States Trustee's fees, attorney fees, accountant fees, postpetition taxes, the real estate commission due and owing to Walter Arnold, and use the remainder to pay the unsecured creditors. Arnold and Baker retained an interest in the property remaining after distribution and sale.

Both FmHA and Western Cotton initially objected to confirmation of Arnold and Baker's second amended plan. However, during the course of the confirmation hearing, Western Cotton reached a settlement with Arnold and Baker pursuant to which Western Cotton agreed to accept 130 acres of real property in full satisfaction of its debt. Western subsequently withdrew its objection to confirmation and voted to accept the plan.

The principal factual issue concentrated on the fair market value of Arnold and Baker's 1320 acres of land. Arnold and Baker estimated the per acre value to be $7,322 for the 640 acre lot, $8,300 for the 360 acre lot, and $8,631 for the 320 acre lot. FmHA estimated the per acre value for the entire 1320 acres at $1,381.

On May 5, 1993, the bankruptcy court confirmed the plan finding that the property had an estimated value of $7,300 per acre. However, the bankruptcy court modified the transfer to FmHA in the plan by ordering an additional 10% transfer to FmHA in order to compensate it for the costs associated with a sale [resulting in a total of 566.5 acres]. [The Bankruptcy Appellate Panel (BAP) reversed.]

Appellant Arnold and Baker argues that the BAP erred in reversing the confirmation of the plan on the ground that the proposed transfer of 566.5 acres to FmHA would not provide "for the realization by [FmHA] of the indubitable equivalent" of its secured claim, as required by § 1129(b)(2)(A)(iii).[5]

Because FmHA objected to confirmation of the plan, Arnold and Baker invoked the "cram down" provision of Chapter 11

The bankruptcy court confirmed the plan on the ground that the plan satisfied the third [indubitable equivalent] requirement. After an evidentiary hearing on the issue of valuation, the court found that the property was worth $7,300 per acre. It then concluded that the receipt of 566.5 acres at $7,300 per acre would provide for FmHA to realize the indubitable equivalent of its secured claim.

As an initial matter, we must address the appropriate standard of review of such a determination. Arnold and Baker argues that the question of indubitable equivalence is a question of fact to be reviewed under the clearly erroneous standard. We disagree. Although the value of the land is a finding of fact which we review for clear error, the ultimate conclusion of indubitable equivalence is a question of law which we review de novo because it requires analysis of the meaning of the statutory language in the context of the Bankruptcy Code's "cram down" scheme.

The BAP reviewed de novo the bankruptcy court's determination that the proposed transfer would provide FmHA with the indubitable equivalent of its secured claim, and reversed. Stressing that "[t]he determination of whether a partial dirt for debt distribution will provide the creditor with the indubitable equivalence of its secured claim must be made on a case-by-case basis," the BAP reasoned that the bankruptcy court's valuation of the property was an insufficient basis on which to conclude that the property was the indubitable equivalent of FmHA's secured claim.

The finding of a trial court of a particular value of real property ... will not necessarily determine whether the creditor will receive the indubitable equivalent of its secured claim. Experience has taught us that determining the value of real property at any given time is not an exact science. Because each parcel of real property is unique, the precise value of land is difficult, if not impossible, to determine until it is actually sold. Nevertheless, bankruptcy courts have traditionally been requested, out of necessity, to determine the value of various types of property, including real property, and yet courts have recognized the difficulty of being able to determine accurately the value of land. For instance, in *In re Walat Farms Inc.*, 70 B.R. 330 (Bankr. E.D. Mich. 1987), the court stated:

> Similarly, we concede to doubts about our ability to fix the "value" of the land in question. We need not make a pronouncement that no plan proposing the surrender of a portion of mortgaged land to a mortgagee in return for a compelled release of the lien on the remainder of the property will ever be confirmed. Suffice it to say, however, that no matter how hot the market for real estate may

> become in the future, the market for farm real estate here and now is not such which would permit us to hold that the value of the land being offered is the indubitable equivalent of [the mortgagee]'s claim. "Indubitable" means "too evident to be doubted." Webster's Ninth New Collegiate Dictionary (1985). We profess doubt on the facts of this case.

[T]he determination of whether a dirt for debt distribution provides a secured creditor with the indubitable equivalent of its secured claim must be made on a case-by-case basis, and we must decide whether the bankruptcy court's finding with respect to the value of the real property for the purpose of determining the amount of the creditor's secured claim provided the secured creditor with the indubitable equivalent of its claim. In addition, we conclude that in order for a partial distribution to constitute the most "indubitable equivalence," the partial distribution must insure the safety of or prevent jeopardy to the principal.

Although we conclude that the bankruptcy court's valuation in this case is not clearly erroneous, we are not convinced that its finding regarding the value of the real property provided the indubitable equivalence of the particular secured claim in question, nor are we convinced that the partial distribution of 566.5 acres to FmHA will insure the safety of or prevent jeopardy to the principal.

The evidence at trial demonstrated that the value of the real property was far from certain. The Arnold and Baker appraisal admitted that due to unfavorable market conditions, including the fact that the [Resolution Trust Company had acquired 19,000 acres near Arnold and Baker's property and was considering bulk sale offers at no more than $2,105 per acre], the normal one year marketing period for the property would be extended by another two years [by which time the appraisal estimated that the Resolution Trust Company's activities would have ceased affecting the market].

The bankruptcy court agreed with Arnold and Baker's valuation of $7,300 per acre. FmHA, however, proffered a valuation of $1,381 per acre. The large disparity in the parties' valuation of the same property illustrates the obvious uncertainty in attempting to forecast the price at which real property will sell at some uncertain future date.

The bankruptcy court found the value of each acre to be $7,300, and thus the value of the 566.5 acres to be transferred to FmHA to be $4,135,450 ($7,300 × 566.5). We must decide, therefore, whether a distribution of land with an estimated value of $4,135,450 constitutes the indubitable equivalent of a $3,837,618 claim secured by 1,320 acres. Under the circumstances of this case, we conclude that it does not.

The partial distribution of 566.5 acres to FmHA will not insure the safety of or prevent jeopardy to the principal. FmHA originally lent funds to Arnold and Baker secured by 1320 acres of land. If Arnold and Baker defaulted on the terms of the note, FmHA bargained for the right to foreclose on the entire 1320 acres of land in order to satisfy the outstanding obligation. In this situation, the principal is protected to the extent of the entire 1320 acres held as security.

If FmHA subsequently sells the property for less than the value calculated by the bankruptcy court, FmHA has no recourse to the remaining collateral to satisfy the deficiency. As a result, the distribution to FmHA may not be "completely compensatory." FmHA is forced to

assume the risk of receiving less on the sale without being able to look to the remaining undistributed collateral for security.

Arnold and Baker challenges the BAP's decision on the ground that it conflicts with *Matter of Sandy Ridge Development Corp*., 881 F.2d 1346 (5th Cir. 1989), in which the Fifth Circuit held that a "dirt for debt" plan satisfied the indubitable equivalence standard. The BAP distinguished *Sandy Ridge* on the ground that the plan in that case provided for the transfer of all of the secured creditor's collateral, rather than only a portion of the collateral as in the present case. Arnold and Baker argues that even in the *Sandy Ridge* situation, the court's valuation of the collateral is critical to the creditor's substantive rights because the valuation directly impacts the creditor's rights regarding an unsecured deficiency claim, as was the case in *Sandy Ridge*.

However, this argument misapprehends the indubitable equivalence analysis. Section 1129(b)(2)(A)(iii) does not require that a creditor receive the indubitable equivalent of its entire claim, but only of its secured claim. [T]he value of the secured portion of an undersecured creditor's total claim is by definition equal to the value of the collateral securing it. Therefore, a creditor necessarily receives the indubitable equivalent of its **secured claim** when it receives the collateral securing that claim, regardless of how the court values the collateral. For this reason, the *Sandy Ridge* court did not need a judicial determination of value, explaining that "for the present analysis, the exact value of [the collateral] is unimportant." The court's valuation of the collateral does, as Arnold and Baker observes, determine the amount of any remaining unsecured claim, but the Code requires only that the creditor receive the indubitable equivalent of its secured claim.

In this case, in contrast, the amount of collateral deemed to be the indubitable equivalent of FmHA's secured claim depends entirely on the court's valuation of the collateral. If the court had found that the land was worth more than $7,300 per acre, FmHA would receive correspondingly less land, and if the court had found that the land was worth less, FmHA would receive correspondingly more. Our holding that this plan does not satisfy the indubitable equivalent requirement is therefore entirely consistent with *Sandy Ridge*'s holding that the plan in that case did.

In conclusion, while we do not hold that the indubitable equivalent standard can never as a matter of law be satisfied when a creditor receives less than the full amount of the collateral originally bargained for, we do hold, as did the BAP, that the Arnold and Baker plan does not provide FmHA with the indubitable equivalent of its secured claim as required by the Bankruptcy Code.

13.10.3.2. BANK OF AMERICA v. 203 N. LaSALLE STREET P'SHIP, 526 U.S. 434 (1999)

JUSTICE SOUTER delivered the opinion of the Court.

Petitioner, Bank of America is the major creditor of the [Debtor], 203 North LaSalle Street Partnership. The Bank lent the Debtor some $93 million, secured by a nonrecourse first mortgage on the Debtor's principal asset, 15 floors of an office building in downtown Chicago. In January 1995, the Debtor defaulted, and the Bank began foreclosure in a state court.

In March, the Debtor responded with a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, which automatically stayed the foreclosure proceedings. The Debtor's principal objective was to ensure that its partners retained title to the property so as to avoid roughly $20 million in personal tax liabilities, which would fall due if the Bank foreclosed. The Debtor proceeded to propose a reorganization plan during the 120-day period when it alone had the right to do so. The Bankruptcy Court rejected the Bank's motion to terminate the period of exclusivity to make way for a plan of its own to liquidate the property, and instead extended the exclusivity period for cause shown, under § 1121(d).

The value of the mortgaged property was less than the balance due the Bank, which elected to divide its undersecured claim into secured and unsecured deficiency claims under § 506(a) and § 1111(b). Under the plan, the Debtor separately classified the Bank's secured claim, its unsecured deficiency claim, and unsecured trade debt owed to other creditors. The Bankruptcy Court found that the Debtor's available assets were prepetition rents in a cash account of $3.1 million and the 15 floors of rental property worth $54.5 million. The secured claim was valued at the latter figure, leaving the Bank with an unsecured deficiency of $38.5 million.

So far as we need be concerned here, the Debtor's plan had these further features:

(1) The Bank's $54.5 million secured claim would be paid in full between 7 and 10 years after the original 1995 repayment date.

(2) The Bank's $38.5 million unsecured deficiency claim would be discharged for an estimated 16% of its present value.

(3) The remaining unsecured claims of $90,000, held by the outside trade creditors, would be paid in full, without interest, on the effective date of the plan.

(4) Certain former partners of the Debtor would contribute $6.125 million in new capital over the course of five years (the contribution being worth some $4.1 million in present value), in exchange for the Partnership's entire ownership of the reorganized debtor.

The last condition was an exclusive eligibility provision: the old equity holders were the only ones who could contribute new capital.

The Bank objected and, being the sole member of an impaired class of creditors, thereby blocked confirmation of the plan on a consensual basis. The Debtor, however, took the alternate route to confirmation of a reorganization plan, forthrightly known as the judicial "cramdown" process for imposing a plan on a dissenting class. § 1129(b).

[The Court reviewed the statutory requirements for cramdown]. As to a dissenting class of impaired unsecured creditors, such a plan may be found to be "fair and equitable" only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, if "the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property," § 1129(b)(2)(B)(ii). That latter condition is the core of what is known as the "absolute priority rule."

The absolute priority rule was the basis for the Bank's position that the plan could not be confirmed as a cramdown. As the Bank read the rule, the plan was open to objection simply because certain old equity holders in the Debtor Partnership would receive property even though

the Bank's unsecured deficiency claim would not be paid in full. The Bankruptcy Court approved the plan nonetheless, and the District Court affirmed, as did the Court of Appeals.

The majority of the Seventh Circuit's divided panel found ambiguity in the language of the statutory absolute priority rule, and looked beyond the text to interpret the phrase "on account of" as permitting recognition of a "new value corollary" to the rule. According to the panel, the corollary, as stated by this Court in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 118 (1939), provides that the objection of an impaired senior class does not bar junior claim holders from receiving or retaining property interests in the debtor after reorganization, if they contribute new capital in money or money's worth, reasonably equivalent to the property's value, and necessary for successful reorganization of the restructured enterprise.

[The Court reviewed the history of reorganizations under the Bankruptcy Act, in which courts adopted the absolute priority rule as a rule of fairness and equity] The second interpretive rule addressed the first. Its classic formulation occurred in *Case v. Los Angeles Lumber Products Co*., in which the Court spoke through Justice Douglas in this dictum:

> It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. . . . Where th[e] necessity [for new capital] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made. . . . [W]e believe that to accord `the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.

Although counsel for one of the parties here has described the *Case* observation as "`black-letter' principle," it never rose above the technical level of dictum in any opinion of this Court, which last addressed it in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), holding that a contribution of "`labor, experience, and expertise' " by a junior interest holder was not in the "`money's worth' " that the *Case* observation required. Nor, prior to the enactment of the current Bankruptcy Code, did any court rely on the *Case* dictum to approve a plan that gave old equity a property right after reorganization. Hence the controversy over how weighty the *Case* dictum had become.

Enactment of the Bankruptcy Code in place of the prior Act might have resolved the status of new value by a provision bearing its name or at least unmistakably couched in its terms, but the Congress chose not to avail itself of that opportunity. In 1973, Congress had considered proposals by the Bankruptcy Commission that included a recommendation to make the absolute priority rule more supple by allowing nonmonetary new value contributions. Although Congress took no action on any of the ensuing bills containing language that would have enacted such an expanded new value concept, each of them was reintroduced in the next congressional session. After extensive hearings, a substantially revised House bill emerged, but without any provision for nonmonetary new value contributions. [The final bill that became law] had no explicit new value language, expansive or otherwise, but did codify the absolute priority rule in nearly its present form.

For the purpose of plumbing the meaning of subsection (b)(2)(B)(ii) in search of a possible statutory new value exception, the lesson of this drafting history is equivocal. Although hornbook law has it that "`Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded,' " the phrase "on account of" is not *silentium*, and the language passed by in this instance had never been in the bill finally enacted, but only in predecessors that died on the vine. None of these contained an explicit codification of the absolute priority rule, and even in these earlier bills the language in question stated an expansive new value concept, not the rule as limited in the *Case* dictum.

The equivocal note of this drafting history is amplified by another feature of the legislative advance toward the current law. Any argument from drafting history has to account for the fact that the Code does not codify any authoritative pre-Code version of the absolute priority rule.

The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.

Three basic interpretations have been suggested for the "on account of" modifier. The first reading is proposed by the Partnership, that "on account of" harks back to accounting practice and means something like "in exchange for," or "in satisfaction of," On this view, a plan would not violate the absolute priority rule unless the old equity holders received or retained property in exchange for the prior interest, without any significant new contribution; if substantial money passed from them as part of the deal, the prohibition of subsection (b)(2)(B)(ii) would not stand in the way, and whatever issues of fairness and equity there might otherwise be would not implicate the "on account of" modifier.

This position is beset with troubles, the first one being textual. Subsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. The second difficulty is practical: the unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if "on account of" meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. "Substantial" or "significant" or "considerable" or like characterizations of a monetary contribution would measure it by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute.

Since the "in exchange for" reading merits rejection, the way is open to recognize the more common understanding of "on account of" to mean "because of." This is certainly the usage meant for the phrase at other places in the statute. . . . So, under the commonsense rule that a given phrase is meant to carry a given concept in a single statute, the better reading of subsection (b)(2)(B)(ii) recognizes that a causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.

The degree of causation is the final bone of contention. We understand the Government, as amicus curiae, to take the starchy position not only that any degree of causation between earlier interests and retained property will activate the bar to a plan providing for later property, but also that whenever the holders of equity in the Debtor end up with some property there will be some

causation; when old equity, and not someone on the street, gets property the reason is res ipsa loquitur. An old equity holder simply cannot take property under a plan if creditors are not paid in full.

There are, however, reasons counting against such a reading. If, as is likely, the drafters were treating junior claimants or interest holders as a class at this point then the simple way to have prohibited the old interest holders from receiving anything over objection would have been to omit the "on account of" phrase entirely from subsection (b)(2)(B)(ii). On this assumption, reading the provision as a blanket prohibition would leave "on account of" as a redundancy, contrary to the interpretive obligation to try to give meaning to all the statutory language. One would also have to ask why Congress would have desired to exclude prior equity categorically from the class of potential owners following a cramdown. Although we have some doubt about the Court of Appeals' assumption that prior equity is often the only source of significant capital for reorganizations, old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.

A less absolute statutory prohibition would follow from reading the "on account of" language as intended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors. Causation between the old equity's holdings and subsequent property substantial enough to disqualify a plan would presumably occur on this view of things **whenever old equity's later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid**. A truly full value transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth, just as *Ahlers* required for application of *Case*`s new value rule.

Which of these positions is ultimately entitled to prevail is not to be decided here, however, for even on the latter view the Bank's objection would require rejection of the plan at issue in this case. **It is doomed**, we can say without necessarily exhausting its flaws, **by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan**. Although the Debtor's exclusive opportunity to propose a plan under § 1121(b) is not itself "property" within the meaning of subsection (b)(2)(B)(ii), the respondent partnership in this case has taken advantage of this opportunity by **proposing a plan under which the benefit of equity ownership may be obtained by no one but old equity partners**. Upon the court's approval of that plan, the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else. It is quite true that the escrow of the partners' proposed investment eliminated any formal need to set out an express option or exclusive dealing provision in the plan itself, since the court's approval that created the opportunity and the partners' action to obtain its advantage were simultaneous. But before the Debtor's plan was accepted no one else could propose an alternative one, and after its acceptance no one else could obtain equity in the reorganized entity. At the moment of the plan's approval the Debtor's partners necessarily enjoyed an exclusive opportunity that was in no economic sense distinguishable from the advantage of the exclusively entitled offeror or option

holder. This opportunity should, first of all, be treated as an item of property in its own right. While it may be argued that the opportunity has no market value, being significant only to old equity holders owing to their potential tax liability, such an argument avails the Debtor nothing, for several reasons. It is to avoid just such arguments that the law is settled that any otherwise cognizable property interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code. Even aside from that rule, the assumption that no one but the Debtor's partners might pay for such an opportunity would obviously support no inference that it is valueless, let alone that it should not be treated as property. And, finally, the source in the tax law of the opportunity's value to the partners implies in no way that it lacks value to others. It might, indeed, be valuable to another precisely as a way to keep the Debtor from implementing a plan that would avoid a Chapter 7 liquidation.

Given that the opportunity is property of some value, the question arises why old equity alone should obtain it, not to mention at no cost whatever. The closest thing to an answer favorable to the Debtor is that the old equity partners would be given the opportunity in the expectation that in taking advantage of it they would add the stated purchase price to the estate. But this just begs the question why the opportunity should be exclusive to the old equity holders. If the price to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. There is no reason, that is, unless the very purpose of the whole transaction is, at least in part, to do old equity a favor. And that, of course, is to say that **old equity would obtain its opportunity, and the resulting benefit, because of old equity's prior interest within the meaning of subsection (b)(2)(B)(ii).** Hence it is that the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of" the old equity position and therefore subject to an unpaid senior creditor class's objection.

[E]ven if we assume that old equity's plan would not be confirmed without satisfying the judge that the purchase price was top dollar, there is a further reason here not to treat property consisting of an exclusive opportunity as subsumed within the total transaction proposed. On the interpretation assumed here, it would, of course, be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar, but this it could not satisfactorily do when it would receive or retain its property under a plan giving it exclusive rights and in the absence of a competing plan of any sort. Under a plan granting an exclusive right, making no provision for competing bids or competing plans, **any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market**.

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

13.10.4. Practice Problems: Confirmation and Cramdown under Chapter 11 (11 U.S.C. § 1129)

Problem 1. Is there a new value exception/corollary to the absolute priority rule? If so, how must the plan be structured to qualify under the exception/corollary?

Problem 2. Debtor wishes to propose a Chapter 11 plan that pays unsecured creditors in full over 5 years with post-confirmation interest at the *Till* rate. Debtor expects unsecured creditors to vote against the plan. Assuming that unsecured creditors would be paid in full right away in a Chapter 7 liquidation, can the plan be confirmed over the unsecured creditors' objections if the equity holders are keeping their stock?

Problem 3. Debtor owes BigBank a total of $12 million. The loan is secured by a first priority mortgage on the Debtor's 10-story office building. The Court has determined that the current fair market value of the office building is $9 million. The prime rate is currently 7%, and the Court will require the payment of 3% over prime under Till. The Court will also not permit a plan term to exceed 20 years. Calculate a monthly payment to be made over a 20 year term that will allow the Debtor to confirm the plan over BigBank's objection if BigBank makes the 1111(b)(2) election, and will also minimize the debtor's interest expense. Note that the courts have interpreted the Bankruptcy Code to require equal monthly payments over the term.

Problem 4. Could the Debtor in Problem (3) confirm the plan while making a lower monthly payment for the same term to BigBank if BigBank did not make the 1111(b)(2) election?

Problem 5. Given your analysis in Problems (3) and (4), when would it be advisable for an undersecured creditor to make the 1111(b)(2) election?

13.11. The Chapter 11 Discharge – 11 U.S.C. § 1141

Section 1141 contains two discharges – one for entities and one for individuals. Entities are discharged from all debts provided for in the plan upon confirmation. 11 U.S.C. § 1141(d)(1). Individuals do not receive a discharge until the plan is completed (11 U.S.C. § 1141(d)(5)(A)), and are not discharged from those debts excepted from discharge under Section 523 (11 U.S.C. § 1141(d)(2)). Note that there are no exceptions to discharge for entities – entities are discharged from all debts other than those provided by the plan, even if they committed terrible acts like fraud, breach of fiduciary duty, and the like. Finally, as in Chapter 13, individuals in Chapter 11 may be eligible for a hardship discharge if they cannot complete the plan but have paid more in present value to creditors than the creditors would have received in Chapter 7. 11 U.S.C. § 1141(d)(5)(B).

13.12. Non-Debtor Discharges, Releases and Injunctions

Section 1141 provides only for the discharge of the debtor's liabilities, and does not provide for the discharge of non-debtor third party liabilities. Moreover, 524(e) of the Bankruptcy Code provides that the discharge "does not affect the liability of any other entity on, or the property of any other entity for, such debt" *Id*.

The debtor can, of course, release its claims against third parties in a plan of reorganization. The more interesting and controversial question is whether the plan can provide for the release of claims by third parties against third parties. There is no reason that a plan could not provide for the discharge of a third party debt as a matter of contract law if the third party debtor agreed to the terms in return for receiving the benefits of the plan. But may a plan of reorganization release a third party from claims without the third party creditor's consent? Can a majority of creditors bind non-consenting creditors to a third party release?

The courts of appeals have been divided on whether a confirmed plan can provide for the release of third party claims without the consent of all third party creditors. The majority of the circuits (the Second, Fourth, Sixth, Seventh and Eleventh Circuits) permit such releases and injunctions, generally resting on the scope of the "all writs" provision in Section 105(a) of the Bankruptcy Code, and two other circuits (the First and D.C. Circuits) have signaled that they accept the majority view. *See In re Drexel Burnham Lambert Grp. Inc*., 960 F.2d 285 (2d Cir. 1992); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002). To support relief, the third party release or injunction must be "essential" to the reorganization, the parties to be released must make substantial financial contributions to the reorganization, and the majority of creditors must support the plan. A minority of the circuits (the Fifth, Ninth and Tenth Circuits) prohibit such injunctions based generally on the prohibition in Section 524(e). *See In re Pacific Lumber Co*., 584 F.3d 329 (5th Cir. 2009); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995).

Recently, in *In re Millennium Lab Holdings II, LLC*, 945 F. 3d 126 (3d Cir. 2019), the Delaware bankruptcy court confirmed a plan that provided for the release by minority creditors of claims against other creditors who were contributing substantial funds to make the plan of reorganization feasible. The plan and reorganization of the debtor depended on the contributions by the settling creditors, who were only willing to fund the plan if they received releases. The Third Circuit held that, under its prior precedents, the bankruptcy court had the power to confirm a plan that released third party claims where the injunctions/releases were "both necessary to the reorganization and fair," and were supported by "specific factual findings to support these conclusions." The circuit rejected the non-consenting creditors' argument that the bankruptcy court lacked the constitutional authority to release third party claims. The Third Circuit also held that the non-consenting creditors' arguments were equitably moot by the substantial consummation and implementation of the plan, because they had failed to obtain a stay pending appeal, and the plan had been implemented.

The issue of non-debtor discharges in a plan of reorganization is currently being decided in an $8.3 billion settlement arising out of the Purdue Pharmaceuticals bankruptcy case pending in New York. Many individuals, states and the federal government have claims against the Sackler family, the owners of Purdue Pharmaceuticals, arising out of the marketing and sales of highly-addictive opioid drugs, including Oxycontin, that were routinely prescribed by doctors for pain management. Creditors allege that Purdue's marketing and sales representations were fraudulent, and were made with the Sackler family's knowledge and participation.

The federal government reached a settlement with the Sackler family which is incorporated into Purdue's bankruptcy plan of reorganization, under which the Sacklers will pay $8.3 billion to a settlement trust and transfer ownership of the company to a public benefit corporation to pay benefits under the plan of reorganization to creditors injured by the drugs. In return, the Sacklers will receive releases of any claims by the states and individuals, whether or not related to opioid

drugs. Nine states objected to the non-debtor releases contained in the plan of reorganization. The bankruptcy court confirmed the plan over the states' objections. There is a likelihood of appeal to the district court, then to the Court of Appeals for the Second Circuit, and ultimately, given the conflicting circuit court opinions, the issue may end up before the Supreme Court.

13.13. Small Business Reorganizations – 11 U.S.C. § 1181 et seq.

In 2019, Congress created a new reorganization option for "Small Business Debtors" in Subchapter V of Chapter 11. Small Business Debtors are defined as persons (individuals or entities) who have not more than $2 million in non-contingent liquidated debts to unaffiliated creditors, secured or unsecured, and whose debts were at least 50% incurred in connection with the debtor's commercial or business activities. 11 U.S.C. § 101(51)(D). Passive single asset real estate investors are specifically excluded from eligibility. *Id*. Many small "mom and pop" businesses will qualify for Subchapter V.

Congress's stated goal was to create a streamlined reorganization process for small businesses, eschewing much of the complexity and cost of the Chapter 11 process. Unless the court for cause orders otherwise, there will be no official creditors committee running up professional fees (11 U.S.C. § 1181(b)), no requirement for the debtor to prepare a formal disclosure statement (*Id*.), and, as we shall see, no need to negotiate and obtain votes for a plan of reorganization (although the debtor may elect to proceed with a negotiated plan if it wants to).

As in a Chapter 13 case, a Chapter 11 trustee is appointed to supervise the collection and distribution of funds under the plan of reorganization, and to provide assistance to the debtor in formulating a plan. 11 U.S.C. § 1183. Unless the bankruptcy court removes the debtor-in-possession for "cause" (dishonesty, incompetence, etc.) (11 U.S.C. § 1185), the debtor remains in control of the business, and is the only party who can file a plan of reorganization (11 U.S.C. § 1189, normally within 90 days after filing, but the period can be extended for any circumstances "for which the debtor should not justly be held accountable").

It appears that the plan period will normally be 3 years from the first payment under the plan, but the court may extend the plan period to 5 years. 11 U.S.C. § 1191(c)(2). It is difficult to see why a debtor would want to propose a plan period longer than 3 years unless additional time was needed to pay secured claims, but the court appears to have the discretion to order a longer plan term (although no standards are given for the court in considering doing so). Presumably, most plan terms will be 3 years.

The big advantage of Subchapter V for debtors is the ability to maintain the business without paying objecting unsecured creditors in full. As you will recall, in a regular Chapter 11 case, the debtor can only cramdown a plan on a rejecting class of unsecured creditors (class does not accept the plan by the 1/2 number 2/3 amount requirement) if the creditors' claims are paid in full with interest, or the equity owners give up their equity interests. *See* 11 U.S.C. § 1129(b)(2)(A).

A debtor under Subchapter V can keep the business without paying dissenting unsecured creditors in full, as long as the debtor pays to creditors all of the debtor's "projected disposable income" during the plan term, or distributes to the creditors property of a value equal to the debtor's "projected disposable income" during the plan term. 11 U.S.C. § 1191(c). "Projected disposable

income" is defined as gross income, less amounts "reasonably necessary to be expended" for maintenance or support of the debtor, a dependent, or payment of a domestic support obligation, or for operation of the business. Thus, only net profits after domestic support and business expenses count as "disposable income." This is very much like the rule under Chapter 13 for under-median debtors, where the court may liberally allow business expenses to reduce payments to unsecured creditors.

Alternatively, a debtor may seek confirmation under the normal voting rules of Chapter 11 for an accepted plan if the debtor can obtain the assent of all impaired classes of creditors under the regular 1/2 in number/2/3 in amount requirement. 11 U.S.C. § 1191(a). Presumably, few debtors will go through the expense of solicitation and voting, unless the debtor has just a few creditors who readily support the reorganization effort.

With one exception, secured creditors must be treated the same way under Subchapter V as under the general Chapter 11 rules: they can be cured, reinstated and paid according to their contract, or if undersecured can be stripped, and the remaining secured claim paid in full with post-petition interest in equal installments during the plan term. *See* 11 U.S.C. §§ 1191(c)(1), 1129(b)(2)(A).

The one exception is home loans, which, as you may recall, cannot be stripped in Chapter 13 cases under Section 1325(b)(5) as interpreted in *Nobelman*, or in Chapter 11 cases under the similar language contained in Section 1123(b)(5). While Subchapter V generally follows the no-stripping-home-mortgages rule, it makes an exception to allow stripping of a **non-purchase money** home loan, where the proceeds of the loan were used "primarily in connection with the small business of the debtor." 11 U.S.C. § 1190(3). A thin exception to be sure, but one that exists under no other chapter of the Bankruptcy Code.

In summary, a small business debtor can confirm a Subchapter V plan that pays only a small distribution to unsecured creditors equal to the projected disposable income during the plan term, as long as creditors receive no less in present value than they would receive in a Chapter 7 liquidation (the best interest test of 11 U.S.C. § 1129(a)(7) must be shown to confirm a Subchapter V plan). The debtor's ability to keep the business over the objection of dissenting creditors who may be paid only a fraction of their claims is the modern financial equivalent alchemy previously sought without success by generations of debtors.

13.13.1. Ted Lasso's Small Business Reorganization Problem

Ted Lasso has owned a family pizzeria in Syracuse called Il Pizzeria de Siracuse for more than 10 years. He owns the business as a sole proprietor, not through a corporation or other entity. The business always did well and was profitable until April 2020, when the Covid-19 virus came. At first, Ted's business started slowly dropping off, but then it dropped off to nothing even though they were continuing to incur their normal business expenses. Finally, Ted was forced to cease operating under government orders.

He wants to reopen his business now that people are going to restaurants again, but he has serious financial problems that need to be addressed. The following financial statements show their current financial condition.

Assets

The first schedule shows Ted's assets, both business assets and personal assets, at both cost and at liquidation value.

Assets	Cost	Liquidation	Lien
Cash in Bank	$ 5,000	$ 5,000	
Pizza Ovens	$ 15,000	$ 4,000	
Other Pizza Equipment	$ 2,500	$ 250	
Pizza Furniture	$ 4,000	$ 500	
Pizza Restaurant Management System	$ 12,000	$ 750	
Car: 2017 Ford F150	$ 45,000	$ 18,000	$ 25,000
Car: 2016 Nissan Leaf	$ 32,000	$ 5,000	$ 7,000
Exempt Furniture & Household Goods	$ 15,000	$ 2,000	
Non-Exempt Household Goods	$ 8,000	$ 1,500	
Home (5BR, 2BA)	$ 275,000	$ 375,000	$ 450,000
Totals	**$ 413,500**	**$ 412,000**	**$482,000**

In addition to his business assets, Ted owns two cars and a home. The cars are worth less than the security purchase money security interests against them, but he would like to keep the cars if possible. The Ford F150 loan is at 14% and has 5 years remaining, and the Nissan Leaf loan is at 15% and has 3 years remaining. Both loans are current. The monthly loan payments are $582 and $243 respectively.

He owns a nice home worth $375,000, but it is over-encumbered in secured debt. He owes $250,000 on the first mortgage (the proceeds of which were used to purchase the property), at 7% interest, and has 20 years left on the mortgage. During the pandemic, he took out a $200,000 second mortgage line of credit at a 16% interest rate, and has 25 years left on the mortgage. He used the proceeds of the second mortgage credit line mostly to pay employees and other business expenses, although about 30% of the funds were used to pay his living expenses. His current monthly payments on the mortgages are $1,767 and $2,718 respectively. He is current on his home loan payments.

Liabilities

Liabilities	
Ford F150 Lien	$ 25,000
Nissan Leaf Lien	$ 7,000
Home Mortgage 1st	$ 250,000
Home Mortgage Line of Credit	$ 200,000
Flour Supplier	$ 45,000
Meat Supplier	$ 35,000
Cheese Supplier	$ 75,000
Sauce Supplier	$ 50,000
Soft Drink Supplier	$ 48,000
Landlord Back Rent	$ 600,000
Landlord Prospective Rent (10 yrs)	$ 6,000,000
Car Accident	$ 1,500,000
Total	$ 8,835,000

In addition to his secured car and mortgage debt, he owes a lot of money to trade suppliers for food purchased during the pandemic, most of which went bad. Ted has not paid rent on the pizza restaurant for the last 12 months (rent is $50,000 per month). He would like to stay in the space, but could move across the street to another space if necessary. There are several places available for the same rent, but it would cost them approximately $15,000 in moving expenses.

Ted's landlord has a contractual claim for $600,000 in back rent. There is 10 years left on the lease, so the full rent for the remaining 10 years would be $6 million (assuming that the landlord could not mitigate by renting the space to someone else). There are several issues regarding the lease. First, could he keep the lease without paying the full $600,000 in back rent (treating the $600,000 as a prepetition unsecured claim)? Second, he is worried that if he rejects the lease and moves to another location, the landlord's claim for future rent would prevent him from qualifying under Subchapter V of Title 11.

Ted also got into a car accident before the pandemic. Ted claims that the accident was the other driver's fault, but the driver has filed a complaint blaming Ted, and is seeking to recover $1,500,000 for personal injuries (claiming neck and back pain). They have $100,000 in insurance coverage, and the insurance company has been defending the case. Ted believes that the driver is faking his injuries.

Projected Disposable Income

Ted has made an attempt to calculate his projected disposable income. He has assumed that his business will generate the same kind of income and costs as it did prior to the pandemic, although he expects that the business may perform a little better when it opens up again because of pent-up demand. He expects however, that business will return to pre-pandemic levels of revenue and costs as the economy returns to normal.

Projected Disposable Income		
Monthly Projected Income		$ 97,000
Monthly Projected Business Expenses		
Rent	$ 50,000	
Meat	$ 3,500	
Cheese	$ 7,500	
Sauce	$ 5,000	
Flour	$ 4,500	
Soft Drinks	$ 4,800	
Employee Wages	$ 9,900	$ (85,200)
Monthly Projected Personal Living Expenses		
First Mortgage (7%)	$ 1,767	
Second Mortgage Contract Rate (16% 25 yrs)	$ 2,718	
F150 Contract Rate (14% 5 Yrs)	$ 582	
Nissan Leaf contract rate (15%, 3 Yrs)	$ 243	
Food & Utilities	$ 650	
Insurance	$ 250	
Membership in the Century Club	$ 500	
College Tuition, Room & Board for Daughter	$ 5,000	$ (11,709)
Projected Disposable Income		**$ 91**

Prior to the pandemic, the business grossed $97,000 per month, and his business expenses run about $85,200 per month, resulting in profitability of about $11,800 per month.

Ted's and his family's living expenses run about $11,709 per month, consisting of their mortgage and car loan payments, food, utilities, car and home insurance, Ted's membership in the prestigious Century Club of Syracuse, a dining and social club for Syracuse's business people, and college expenses for their daughter Leslie Lasso, who is finishing her freshman year at Syracuse University.

QUESTION 1

Your office represents the Lassos, and you have been asked to develop a plan of reorganization under Subchapter V of Title 11 to reorganize their business.

You will first have to determine whether the Lassos can qualify under the debt limits for Subchapter V.

Second, you will need to determine how to treat their secured claims in bankruptcy. Syracuse courts traditionally use an interest rate of 6% per annum under *Till v. SCS* when calculating payments.

Third, you will need to determine how much he will need to pay to general unsecured creditors on a monthly basis, and whether the plan will be feasible.

Finally, you will need to perform a liquidation analysis to show that Lasso is paying more to creditors than they would get in a liquidation. 11 U.S.C. §§ 1129(a)(7), 1191(b).

Ted assumes that his creditors will not cooperate with him, and he would like to avoid the expense of negotiating and soliciting votes. He's hoping that you can develop a plan that will meet the requirements for confirmation without needing creditor cooperation.

QUESTION 2

After you have developed a Subchapter V plan, imagine that you are the creditors and want to derail the reorganization. What objections would you make? Would your objections prevail? What changes would you, as Lasso's lawyer, advise him to make to most easily confirm a plan of reorganization that he can afford?

Chapter 14. Protecting the Integrity of the Bankruptcy Process

The Bankruptcy Code contains a great deal of flexibility for a debtor seeking to operate a business. Just about anything can be done during the bankruptcy case with the approval of the bankruptcy court, after notice and an opportunity for a hearing, including the use, sale or lease of the debtor's money or property out of the ordinary course of business under Section 363(b)(1) of the Bankruptcy Code, as long as secured creditors are "adequately protected."

This pre-confirmation flexibility can come into conflict with the plan confirmation process. It is a fundamental bankruptcy principle that all similarly situated creditors receive the same treatment. Furthermore, at least outside of the small business provisions of Chapter V, Chapter 11 reorganizations require a detailed disclosure and voting process, and a strict cramdown process assuring that all creditors are both better off than they would be in a liquidation, and that the absolute priority rule is met for dissenting classes of creditors.

Can these fundamental protections contained in the Chapter 11 plan process be avoided during the bankruptcy case? For example, would an order allowing the debtor to pay in full certain favored unsecured claims while other unsecured creditors in the same class go largely unpaid violate Chapter 11's equality of distribution principle? Can the disclosure and voting provisions be bypassed through the clever use of a pre-plan bankruptcy sale of all assets? The cases that follow, which were shocking to the bankruptcy community when issued, emphasize that the bankruptcy judge must carefully consider and justify the decision to allow a debtor or trustee to act outside of a plan when fundamental bankruptcy principles are at stake.

14.1. IN RE LIONEL CORPORATION, 722 F.2d 1063 (2d Cir. 1983)

This expedited appeal is from [lower court orders authorizing] the sale by Lionel Corporation, a Chapter 11 debtor in possession, of its 82% common stock holding in Dale Electronics, Inc. to Peabody International Corporation for $50 million.

On February 19, 1982 the Lionel Corporation--toy train manufacturer of childhood memory-- filed petitions for reorganization under Chapter 11 of the Bankruptcy Code. Resort to Chapter 11 was precipitated by losses totaling $22.5 million that Lionel incurred in its toy retailing operation during the two year period ending December 1982. Lionel continues to operate its businesses and manage its properties.

Lionel's most important asset and the subject of this proceeding is its ownership of 82% of the common stock of Dale, a corporation engaged in the manufacture of electronic components. Dale is not a party to the Lionel bankruptcy proceeding. Public investors own the remaining 18 percent of Dale's common stock, which is listed on the American Stock Exchange. Lionel's investment in Dale is Lionel's most valuable single asset. Unlike Lionel's toy retailing operation, Dale is profitable. For the same two-year period ending in December 1982 during which Lionel had incurred its substantial losses, Dale had an aggregate operating profit of $18.8 million.

On June 14, 1983 Lionel filed an application under section 363(b) seeking bankruptcy court authorization to sell its 82% interest in Dale to Acme-Cleveland Corporation for $43 million in cash. Four days later the debtor filed a plan of reorganization conditioned upon a sale of Dale with

the proceeds to be distributed to creditors. Bankruptcy Judge Ryan held a hearing on Lionel's application. At the hearing, Peabody emerged as the successful of three bidders with an offer of $50 million for Lionel's interest in Dale.

The Chief Executive Officer of Lionel and a Vice-President of Salomon Brothers were the only witnesses produced and both testified in support of the application. Their testimony established that while the price paid for the stock was "fair," Dale is not an asset "that is wasting away in any sense." Lionel's Chief Executive Officer stated that there was no reason why the sale of Dale stock could not be accomplished as part of the reorganization plan, and that the sole reason for Lionel's application to sell was the Creditors' Committee's insistence upon it. The creditors wanted to turn this asset of Lionel into a "pot of cash," to provide the bulk of the $70 million required to repay creditors under the proposed plan of reorganization.

In confirming the sale, Judge Ryan made no formal findings of fact. He simply noted that cause to sell was sufficiently shown by the Creditors' Committee's insistence upon it.

The Committee of Equity Security Holders, statutory representatives of the 10,000 public shareholders of Lionel, appealed this order claiming that the sale, prior to approval of a reorganization plan, deprives the equity holders of the Bankruptcy Code's safeguards of disclosure, solicitation and acceptance and divests the debtor of a dominant and profitable asset which could serve as a cornerstone for a sound plan. The SEC also appeared and objected to the sale in the bankruptcy court and supports the Equity Committee's appeal, claiming that approval of the sale side-steps the Code's requirement for informed suffrage which is at the heart of Chapter 11.

From the oral arguments and briefs we gather that the Equity Committee believes that Chapter 11 has cleared the reorganization field of major pre-plan sales--somewhat like the way Minerva routed Mars--relegating Sec. 363(b) to be used only in emergencies. The Creditors' Committee counters that a bankruptcy judge should have absolute freedom under Sec. 363(b) to do as he thinks best. Neither of these arguments is wholly persuasive. Here, as in so many similar cases, we must avoid the extremes, for the policies underlying the Bankruptcy Reform Act of 1978 support a middle ground--one which gives the bankruptcy judge considerable discretion yet requires him to articulate sound business justifications for his decisions.

On its face, section 363(b) appears to permit disposition of any property of the estate of a corporate debtor without resort to the statutory safeguards embodied in Chapter 11 of the Bankruptcy Code. Yet, analysis of the statute's history and over seven decades of case law convinces us that such a literal reading of section 363(b) would unnecessarily violate the congressional scheme for corporate reorganizations.

A. Prior bankruptcy Acts --the "Perishable" Standard

The 1867 Act did not provide for reorganizations; nevertheless, the requirements that the property be of a perishable nature or liable to deteriorate in value and that there be loss if the same is not sold immediately were also found in General Bankruptcy Order No. XVIII(3), adopted by the Supreme Court in 1898.

From 1898 through 1937, the Bankruptcy Act did not contain a specific provision permitting pre-adjudication sales of a debtor's property. But, pursuant to General Order XVIII, this Circuit over fifty years ago upheld an order that approved a private, pre-adjudication sale of a bankrupt's stock of handkerchiefs. Not only was merchandise sold at a price above its appraised

value, but Christmas sales had commenced and the sale of handkerchiefs would decline greatly after the holidays. Our court held that the concept of "perishable" was not limited to its physical meaning, but also included property liable to deteriorate in price and value.

B. Chandler Act of 1938--The "Upon Cause Shown" Standard

When reorganization became part of the bankruptcy law, the long established administrative powers of the court to sell a debtor's property prior to adjudication were extended to cover reorganizations. The Rules of Bankruptcy Procedure provided for a sale of all or part of a bankrupt's property after application to the court and "upon cause shown." Despite the provisions of this Rule, the "perishable" concept, expressed in the view that a pre-confirmation or pre-adjudication sale was the exception and not the rule, persisted. As one commentator stated, "[o]rdinarily, in the absence of perishable goods, or depreciation of assets, or actual jeopardy of the estate, a sale will not be ordered, particularly prior to adjudication."

[Later] in *Frank v. Drinc-O-Matic, Inc.*, 136 F.2d 906 (2d Cir.1943), we upheld the sale of a debtor's 19 vending machines that were subject to a vendor's lien and in the possession of their manufacturer. We noted that the trustee had no funds with which to redeem the machines and that six months had passed from the filing of the petition without proposal of a reorganization plan. Citing Sec. 116(3) of the Act, we next affirmed an order of a sale of vats, kettles and other brewing machinery which, with "'the approach of warm weather ... will, because of lack of use and refrigeration, deteriorate rapidly and lose substantially all their value.'" *In re V. Loewer's Gambrinus Brewery Co.*, 141 F.2d 747, 748 (2d Cir. 1944). While the court acknowledged the viability of the "perishable" property concept, it upheld the sale even though virtually all of the income producing assets of the debtor were involved. The same proceeding, then entitled *Patent Cereals v. Flynn*, 149 F.2d 711 (2d Cir.1945), came before us the following year. We said it made no difference whether sale of a debtor's property preceded or was made part of a plan of reorganization. Nothing, we continued, in former section 216 (providing for the sale of a reorganizing debtor's property pursuant to a plan) precluded approval of a plan after a sale of all or a substantial part of the debtor's property. Section 216 merely permitted a plan providing for such sale and did not forbid a plan after such a sale has already taken place.

Judge Ryan, in authorizing the sale of the Dale stock cited *Patent Cereals* as his authority. Appellees here cite *Patent Cereals* for the proposition that this court has abandoned the perishable property or emergency concept. We reject such a broad reading of *Patent Cereals* for several reasons. First, the decision involved an appeal from a denial of confirmation of a plan of reorganization, i.e., the sale in that case was a fait accompli, it was not as here an appeal from an authorization of sale. Second, the earlier decision in *Loewer's Gambrinus Brewery*, indicates that the court did view the original sale as involving perishable property. Third, subsequent cases in this Circuit confirm the misapprehension in appellees' and Judge Ryan's broad interpretation.

The Third Circuit took an even stricter view in *In re Solar Mfg. Corp.*, 176 F.2d 493 (3d Cir.1949). [T]he court concluded that pre-confirmation sales should be "confined to emergencies where there is imminent danger that the assets of the ailing business will be lost if prompt action is not taken." This "emergency" approach was so appealing that our court cited Solar Mfg. Corp. with approval and held in *In re Pure Penn Petroleum Co.*, 188 F.2d 851 (2d Cir.1951), that the debtor must plead and prove "the existence of an emergency involving imminent danger of loss of the assets if they were not promptly sold."

Finally, in *In re Sire Plan, Inc.*, 332 F.2d 497 (2d Cir.1964), corporate owners of a seven-story skeletal building then under construction filed for reorganization under Chapter X of the Act. Because of the site's close proximity to the impending 1964 World's Fair, Holiday Inns felt it was a favorable location for a hotel and accordingly offered to purchase it. The sale to Holiday Inns was affirmed under the Patent Cereal rationale. The Court stated that there is no requirement that the sale be in aid of a reorganization; but we further noted, as in *Pure Penn*, that the evidence demonstrated that in its exposed state a "partially constructed building is a 'wasting asset' [that] can only deteriorate in value the longer it remains uncompleted."

More recently, other circuits have upheld sales prior to plan approval under the Bankruptcy Act where the bankruptcy court outlined the circumstances in its findings of fact indicating why the sale was in the best interest of the estate.

C. The Bankruptcy Reform Act of 1978

Section 363(b) of the Code seems on its face to confer upon the bankruptcy judge virtually unfettered discretion to authorize the use, sale or lease, other than in the ordinary course of business, of property of the estate. Of course, the statute requires that notice be given and a hearing conducted, but no reference is made to an "emergency" or "perishability" requirement nor is there an indication that a debtor in possession or trustee contemplating sale must show "cause." Thus, the language of Sec. 363(b) clearly is different from the terms of its statutory predecessors. And, while Congress never expressly stated why it abandoned the "upon cause shown" terminology of Sec. 116(3), arguably that omission permits easier access to Sec. 363(b). Various policy considerations lend some support to this view.

First and foremost is the notion that a bankruptcy judge must not be shackled with unnecessarily rigid rules when exercising the undoubtedly broad administrative power granted him under the Code.

Support for this policy is found in the rationale underlying a number of earlier cases that had applied Sec. 116(3) of the Act. In particular, this Court's decision in *Sire Plan* was not hinged on an "emergency" or "perishability" concept. Lip service was paid to the argument that a partially constructed building is a "wasting asset;" but the real justification for authorizing the sale was the belief that the property's value depended on whether a hotel could be built in time for the World's Fair and that an advantageous sale after the opening of the World's Fair seemed unlikely. Thus, the reason was not solely that a steel skeleton was deteriorating, but rather that a good business opportunity was presently available, so long as the parties could act quickly. In such cases therefore the bankruptcy machinery should not straightjacket the bankruptcy judge so as to prevent him from doing what is best for the estate.

Just as we reject the requirement that only an emergency permits the use of Sec. 363(b), we also reject the view that Sec. 363(b) grants the bankruptcy judge carte blanche.

The history surrounding the enactment in 1978 of current Chapter 11 and the logic underlying it buttress our conclusion that there must be some articulated business justification, other than appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under section 363(b).

The case law under section 363's statutory predecessors used terms like "perishable," "deteriorating," and "emergency" as guides in deciding whether a debtor's property could be sold

outside the ordinary course of business. The use of such words persisted long after their omission from newer statutes and rules. The administrative power to sell or lease property in a reorganization continued to be the exception, not the rule. In enacting the 1978 Code Congress was aware of existing case law and clearly indicated as one of its purposes that equity interests have a greater voice in reorganization plans--hence, the safeguards of disclosure, voting, acceptance and confirmation in present Chapter 11.

Resolving the apparent conflict between Chapter 11 and Sec. 363(b) does not require an all or nothing approach. Every sale under Sec. 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then--like the related yet independent tasks performed in modern production techniques to ensure good results--some play for the operation of both Sec. 363(b) and Chapter 11 must be allowed for.

The rule we adopt requires that a judge determining a Sec. 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application. In this case the only reason advanced for granting the request to sell Lionel's 82 percent stock interest in Dale was the Creditors' Committee's insistence on it. Such is insufficient as a matter of fact because it is not a sound business reason and insufficient as a matter of law because it ignores the equity interests required to be weighed and considered under Chapter 11. The court also expressed its concern that a present failure to approve the sale would result in a long delay. As the Supreme Court has noted, it is easy to sympathize with the desire of a bankruptcy court to expedite bankruptcy reorganization proceedings for they are frequently protracted. "The need for expedition, however, is not a justification for abandoning proper standards."

Accordingly, the order appealed from is reversed and the matter remanded to the district court with directions to remand to the bankruptcy court for further proceedings consistent with this opinion.

14.2. IN RE CHRYSLER, 576 F.3d 108 (2d Cir. 2009)

[Secured Creditors] (collectively, the "Indiana Pensioners" or "Pensioners"), along with various tort claimants and others, appeal from an order entered in the United States Bankruptcy Court for the Southern District of New York, Arthur J. Gonzalez, Bankruptcy Judge, dated June 1, 2009 (the "Sale Order"), authorizing the sale of substantially all of the debtor's assets to New CarCo Acquisition LLC ("New Chrysler"). On June 2, 2009 we granted the Indiana Pensioners' motion for a stay and for expedited appeal directly to this Court, pursuant to 28 U.S.C. § 158(d)(2). On June 5, 2009 we heard oral argument, and ruled from the bench and by written order, affirming the Sale Order "for the reasons stated in the opinions of Bankruptcy Judge Gonzalez," stating that an opinion or opinions would follow. This is the opinion.

In a nutshell, Chrysler and its related companies filed a prepackaged bankruptcy petition under Chapter 11 on April 30, 2009. The filing followed months in which Chrysler experienced deepening losses, received billions in bailout funds from the Federal Government, searched for a merger partner, unsuccessfully sought additional government bailout funds for a stand-alone restructuring, and ultimately settled on an asset-sale transaction pursuant to 11 U.S.C. § 363 (the

"Sale"), which was approved by the Sale Order. The key elements of the Sale were: substantially all of Chrysler's operating assets (including manufacturing plants, brand names, certain dealer and supplier relationships, and much else) would be transferred to New Chrysler in exchange for New Chrysler's assumption of certain liabilities and $2 billion in cash. Fiat S.p.A agreed to provide New Chrysler with certain fuel-efficient vehicle platforms, access to its worldwide distribution system, and new management that is experienced in turning around a failing auto company. Financing for the sale transaction—$6 billion in senior secured financing, and debtor in possession financing for 60 days in the amount of $4.96 billion—would come from the United States Treasury and from Export Development Canada. Ownership of New Chrysler was to be distributed by membership interests, 55% of which go to an employee benefit entity created by the United Auto Workers union, 8% to the United States Treasury and 2% to Export Development Canada. Fiat, for its contributions, would immediately own 20% of the equity with rights to acquire more (up to 51%), contingent on payment in full of the debts owed to the United States Treasury and Export Development Canada.

[The bankruptcy court allowed other bids. After no other bids were forthcoming], the bankruptcy court approved the Sale by order dated June 1, 2009.

After briefing and oral argument, we affirmed the bankruptcy court's order on June 5, but we entered a short stay pending Supreme Court review. The Supreme Court, after an extension of the stay, declined a further extension. The Sale closed on June 10, 2009.

[I]t is contended that the sale of Chrysler's auto-manufacturing assets, considered together with the associated intellectual property and (selected) dealership contractual rights, so closely approximates a final plan of reorganization that it constitutes an impermissible "sub rosa plan," and therefore cannot be accomplished under § 363(b).

DISCUSSION

The Indiana Pensioners characterize the Sale as an impermissible, sub rosa plan of reorganization. As the Indiana Pensioners characterize it, the Sale transaction "is a `Sale' in name only; upon consummation, new Chrysler will be old Chrysler in essentially every respect. It will be called `Chrysler.' Its employees, including most management, will be retained.... It will manufacture and sell Chrysler and Dodge cars and minivans, Jeeps and Dodge Trucks.... The real substance of the transaction is the underlying reorganization it implements."

Section 363(b) of the Bankruptcy Code authorizes a Chapter 11 debtor in possession to use, sell, or lease estate property outside the ordinary course of business, requiring in most circumstances only that a movant provide notice and a hearing. 11 U.S.C. § 363(b). We have identified an "apparent conflict" between the expedient of a § 363(b) sale and the otherwise applicable features and safeguards of Chapter 11. *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir.1983).

In *Lionel*, we consulted the history and purpose of § 363(b) to situate § 363(b) transactions within the overall structure of Chapter 11. The origin of § 363(b) is the Bankruptcy Act of 1867, which permitted a sale of a debtor's assets when the estate or any part thereof was "of a perishable nature or liable to deteriorate in value." Typically, courts have approved § 363(b) sales to preserve "`wasting asset[s].'" Most early transactions concerned perishable commodities; but the same practical necessity has been recognized in contexts other than fruits and vegetables. "[T]here are times when it is more advantageous for the debtor to begin to sell as many assets as quickly as

possible in order to insure that the assets do not lose value." Thus, an automobile manufacturing business can be within the ambit of the "melting ice cube" theory of § 363(b). As *Lionel* recognized, the text of § 363(b) requires no "emergency" to justify approval. For example, if "a good business opportunity [is] presently available," which might soon disappear, quick action may be justified in order to increase (or maintain) the value of an asset to the estate, by means of a lease or sale of the assets. Accordingly, *Lionel* rejected the requirement that only an emergency permits the use of § 363(b). If a bankruptcy judge is to administer a business reorganization successfully under the Code, then ... some play for the operation of both § 363(b) and Chapter 11 must be allowed for.

At the same time, *Lionel* reject[ed] the view that § 363(b) grants the bankruptcy judge carte blanche. The concern was that a quick, plenary sale of assets outside the ordinary course of business risked circumventing key features of the Chapter 11 process, which afford debt and equity holders the opportunity to vote on a proposed plan of reorganization after receiving meaningful information. Pushed by a bullying creditor, a § 363(b) sale might evade such requirements as disclosure, solicitation, acceptance, and confirmation of a plan. "[T]he natural tendency of a debtor in distress," as a Senate Judiciary Committee Report observed, is "to pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors." *Lionel*, 722 F.2d at 1070 (quoting S.Rep. No. 95-989, 2d Sess., at 10 (1978)).

To balance the competing concerns of efficiency against the safeguards of the Chapter 11 process, Lionel required a "good business reason" for a § 363(b) transaction.

In the twenty-five years since *Lionel*, § 363(b) asset sales have become common practice in large-scale corporate bankruptcies. In the current economic crisis of 2008-09, § 363(b) sales have become even more useful and customary. The "side door" of § 363(b) may well "replace the main route of Chapter 11 reorganization plans."

Resort to § 363(b) has been driven by efficiency, from the perspectives of sellers and buyers alike. The speed of the process can maximize asset value by sale of the debtor's business as a going concern. Moreover, the assets are typically burnished (or "cleansed") because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities. A § 363 sale can often yield the highest price for the assets because the buyer can select the liabilities it will assume and purchase a business with cash flow (or the near prospect of it). Often, a secured creditor can "credit bid," or take an ownership interest in the company by bidding a reduction in the debt the company owes. See 11 U.S.C. § 363(k).

This tendency has its critics. The objections are not to the quantity or percentage of assets being sold: it has long been understood by the drafters of the Code, and the Supreme Court that § 363(b) sales may encompass all or substantially all of a debtor's assets. Rather, the thrust of criticism remains what it was in *Lionel*: fear that one class of creditors may strong-arm the debtor in possession, and bypass the requirements of Chapter 11 to cash out quickly at the expense of other stakeholders, in a proceeding that amounts to a reorganization in all but name, achieved by stealth and momentum.

As § 363(b) sales proliferate, the competing concerns identified in Lionel have become harder to manage. Debtors need flexibility and speed to preserve going concern value; yet one or more classes of creditors should not be able to nullify Chapter 11's requirements. A balance is not easy to achieve, and is not aided by rigid rules and prescriptions. *Lionel's* multi-factor analysis

remains the proper, most comprehensive framework for judging the validity of § 363(b) transactions.

Adopting the Fifth Circuit's wording in *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983), commentators and courts—including ours—have sometimes referred to improper § 363(b) transactions as "sub rosa plans of reorganization." *Braniff* rejected a proposed transfer agreement in large part because the terms of the agreement specifically attempted to "dictat[e] some of the terms of any future reorganization plan. The [subsequent] reorganization plan would have to allocate the [proceeds of the sale] according to the terms of the [transfer] agreement or forfeit a valuable asset." 700 F.2d at 940. As the Fifth Circuit concluded, "[t]he debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with a sale of assets." *Id.*

The term "*sub rosa*" is something of a misnomer. It bespeaks a covert or secret activity, whereas secrecy has nothing to do with a § 363 transaction. Transactions blessed by the bankruptcy courts are openly presented, considered, approved, and implemented. *Braniff* seems to have used "*sub rosa*" to describe transactions that treat the requirements of the Bankruptcy Code as something to be evaded or subverted. But even in that sense, the term is unhelpful. The sale of assets is permissible under § 363(b); and it is elementary that the more assets sold that way, the less will be left for a plan of reorganization, or for liquidation. But the size of the transaction, and the residuum of corporate assets, is, under our precedent, just one consideration for the exercise of discretion by the bankruptcy judge(s), along with an open-ended list of other salient factors.

Braniff's holding did not support the argument that a § 363(b) asset sale must be rejected simply because it is a sale of all or substantially all of a debtor's assets. Thus a § 363(b) sale may well be a reorganization in effect without being the kind of plan rejected in *Braniff*. Although Lionel did not involve a contention that the proposed sale was a *sub rosa* or de facto reorganization, a bankruptcy court confronted with that allegation may approve or disapprove a § 363(b) transfer that is a sale of all or substantially all of a debtor's assets, using the analysis set forth in Lionel in order to determine whether there was a good business reason for the sale.

The Indiana Pensioners argue that the Sale is a *sub rosa* plan chiefly because it gives value to unsecured creditors (i.e., in the form of the ownership interest in New Chrysler provided to the union benefit funds) without paying off secured debt in full, and without complying with the procedural requirements of Chapter 11. However, Bankruptcy Judge Gonzalez demonstrated proper solicitude for the priority between creditors and deemed it essential that the Sale in no way upset that priority. The lien holders' security interests would attach to all proceeds of the Sale: "Not one penny of value of the Debtors' assets is going to anyone other than the First-Lien Lenders." Sale Opinion at 18. As Bankruptcy Judge Gonzalez found, all the equity stakes in New Chrysler were entirely attributable to new value—including governmental loans, new technology, and new management—which were not assets of the debtor's estate. *Id.* at 22-23.

The Indiana Pensioners' arguments boil down to the complaint that the Sale does not pass the discretionary, multifarious *Lionel* test. The bankruptcy court's findings constitute an adequate rebuttal. Applying the *Lionel* factors, Bankruptcy Judge Gonzalez found good business reasons for the Sale. The linchpin of his analysis was that the only possible alternative to the Sale was an immediate liquidation that would yield far less for the estate—and for the objectors. The court

found that, notwithstanding Chrysler's prolonged and well-publicized efforts to find a strategic partner or buyer, no other proposals were forthcoming. In the months leading up to Chrysler's bankruptcy filing, and during the bankruptcy process itself, Chrysler executives circled the globe in search of a deal. But the Fiat transaction was the only offer available. [Judge Gonzalez found that] "the only other alternative is the immediate liquidation of the company.").

The Sale would yield $2 billion. According to expert testimony—not refuted by the objectors—an immediate liquidation of Chrysler as of May 20, 2009 would yield in the range of nothing to $800 million. Crucially, Fiat had conditioned its commitment on the Sale being completed by June 15, 2009. While this deadline was tight and seemingly arbitrary, there was little leverage to force an extension. To preserve resources, Chrysler factories had been shuttered, and the business was hemorrhaging cash. According to the bankruptcy court, Chrysler was losing going concern value of nearly $100 million each day.

On this record, and in light of the arguments made by the parties, the bankruptcy court's approval of the Sale was no abuse of discretion. With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube. Going concern value was being reduced each passing day that it produced no cars, yet was obliged to pay rents, overhead, and salaries. Consistent with an underlying purpose of the Bankruptcy Code—maximizing the value of the bankrupt estate—it was no abuse of discretion to determine that the Sale prevented further, unnecessary losses.

The Indiana Pensioners exaggerate the extent to which New Chrysler will emerge from the Sale as the twin of Old Chrysler. New Chrysler may manufacture the same lines of cars but it will also make newer, smaller vehicles using Fiat technology that will become available as a result of the Sale—moreover, at the time of the proceedings, Old Chrysler was manufacturing no cars at all. New Chrysler will be run by a new Chief Executive Officer, who has experience in turning around failing auto companies. It may retain many of the same employees, but they will be working under new union contracts that contain a six-year no-strike provision. New Chrysler will still sell cars in some of its old dealerships in the United States, but it will also have new access to Fiat dealerships in the European market. Such transformative use of old and new assets is precisely what one would expect from the § 363(b) sale of a going concern.

Affirmed.

[Editor's Note: In the full opinion, the Chrysler court rejected a number of other arguments made by the appellants. The Court held that the Indiana Pensioners, who were participants with others in a secured loan, ceded to a joint trustee the power to consent to the sale. Since the trustee consented, the Indiana Pensioners were bound by that consent. The Court also held that the Indiana Pensioners lacked standing to challenge the use of the Federal Government's TARP money to fund the plan. The court validated the terms which gave New Chrysler the assets free and clear of existing product liability claims, rejecting the Indiana Pensioners' argument that section 363(f) only allows the sale of assets "free and clear of interests" and not "free and clear of all claims and interests" which would be permitted only under a confirmed Chapter 11 plan under section 1141(c). The court rejected the argument that the language of section 363(f) is narrower than the language of 1141(c). Instead, the Court held that the two provisions should be "harmonized." Finally, like the court in *Manville*, the Chrysler court held that the Indiana Pensioners lacked standing to challenge the scope of the release on behalf of future creditors.

The Chrysler court left *Lionel's* analytical framework in place, but with a very different emphasis. It is difficult to know if that pro-sale emphasis was due to the national emergency of the Great Recession, with the federal government and proponents of the sale claiming that the American economy's recovery depended on a favorable decision approving the sale, or whether the courts will generally defer to the "melting ice cube" arguments of the sale proponents in cases where the stakes are not so momentous. Since Lehman Brothers, Chrysler, and GM, early Section 363 sales have continued to be the predominant method of reorganization in large corporate cases. But the pendulum may one day swing back against early sales that have the effect of bypassing the reorganization structure of Chapter 11.]

14.3. IN THE MATTER OF KMART CORPORATION, 359 F.3d 866 (7th Cir. 2004)

On the first day of its bankruptcy, Kmart sought permission to pay immediately, and in full, the pre-petition claims of all "critical vendors." The theory behind the request is that some suppliers may be unwilling to do business with a customer that is behind in payment, and, if it cannot obtain the merchandise that its own customers have come to expect, a firm such as Kmart may be unable to carry on, injuring all of its creditors. Full payment to critical vendors thus could in principle make even the disfavored creditors better off: they may not be paid in full, but they will receive a greater portion of their claims than they would if the critical vendors cut off supplies and the business shut down. Putting the proposition in this way implies, however, that the debtor must prove, and not just allege, two things: that, but for immediate full payment, vendors would cease dealing; and that the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off.

Bankruptcy Judge Sonderby entered a critical-vendors order just as Kmart proposed it, without notifying any disfavored creditors, without receiving any pertinent evidence, and without making any finding of fact that the disfavored creditors would gain or come out even. The bankruptcy court's order declared that the relief Kmart requested — open-ended permission to pay any debt to any vendor it deemed "critical" in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on "customary trade terms" for the next two years — was "in the best interests of the Debtors, their estates and their creditors".

Kmart used its authority to pay in full the pre-petition debts to 2,330 suppliers, which collectively received about $300 million. This came from the $2 billion in new credit (debtor in possession or DIP financing) that the bankruptcy judge authorized, granting the lenders super-priority in post-petition assets and revenues. Another 2,000 or so vendors were not deemed "critical" and were not paid. They and 43,000 additional unsecured creditors eventually received about 10¢ on the dollar, mostly in stock of the reorganized Kmart.

Capital Factors, Inc., appealed the critical-vendors order immediately after its entry on January 25, 2002. A little more than 14 months later, after all of the critical vendors had been paid and as Kmart's plan of reorganization was on the verge of approval, District Judge Grady reversed the order authorizing payment. He concluded that neither § 105(a) nor a "doctrine of necessity" supports the orders.

Appellants insist that, by the time Judge Grady acted, it was too late. Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization. If the orders in question are invalid, then the critical vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors.

Appellants say that we should recognize their reliance interests: after the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts). Continued business relations may or may not be a form of reliance (that depends on whether the vendors otherwise would have stopped selling), but they are not detrimental reliance. The vendors have been paid in full for post-petition goods and services. If Kmart had become administratively insolvent, and unable to compensate the vendors for post-petition transactions, then it might make sense to permit vendors to retain payments under the critical-vendors order, at least to the extent of the post-petition deficiency. Because Kmart emerged as an operating business, however, no such question arises.

Thus we arrive at the merits. Section 105(a) allows a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code. This does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by § 105(a) is one to implement rather than override. Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.

A "doctrine of necessity" is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of "necessity," today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text.

So does the Code contain any grant of authority for debtors to prefer some vendors over others? Many sections require equal treatment or specify the details of priority when assets are insufficient to satisfy all claims. Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses. Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow. Treating pre-filing debts as "administrative" claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.

That leaves § 363(b)(1): "The trustee [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a pre-petition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. We need not decide whether § 363(b)(1) could support payment of some pre-petition debts, because this order was unsound no matter how one reads § 363(b)(1).

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. If paying the critical vendors would enable a successful reorganization and make even the

disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. For the premise to hold true, however, it is necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation — a demonstration never attempted in this proceeding — but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries. Fleming Companies, which received the largest critical-vendors payment because it sold Kmart between $70 million and $100 million of groceries and related goods weekly, was one of these. No matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make. Nor was Fleming likely to walk away even if it had a legal right to do so. Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean. Again Fleming illustrates the point. When Kmart stopped buying its products after the contract expired, Fleming collapsed (Kmart had accounted for more than 50% of its business) and filed its own bankruptcy petition. Fleming was hardly likely to have quit selling of its own volition, only to expire the sooner.

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for pre-petition transactions. Kmart could have paid cash or its equivalent.

Yet the bankruptcy court did not explore [other methods] to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. Even if § 362(b)(1) allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.

14.4. Reconfiguring the Bankruptcy Estate: Substantive Consolidation

Bankruptcy courts have the equitable power to ignore the separate existence of two or more legally distinct entities and "substantively consolidate" them as one entity in a bankruptcy case. Although the standards for substantive consolidation vary by jurisdiction, this equitable power is generally only used when there has been either a substantial commingling of assets between the entities, or the entities have dealt with the creditors in a manner that does not properly regard the entities' separate existence. *E.g*. *Federal Dep. Ins. Corp. v. Colonial Realty Co.*, 966 F.2d 57, 58-59 (2d Cir. 1992); *In re Bonham*, 229 F.3d 750, 766 (9th Cir. 2000). The courts also recognize that substantive consolidation is an extraordinary remedy that should be used only when creditors would not be harmed for their reliance on the separate existence of the entities, or when as a result of extreme commingling and disregard of corporate separateness there is no practical way to recognize the separate existence of the entities or unscramble their assets and affairs. [6]

The courts' power to order substantive consolidation is not found in any provision of the Bankruptcy Code, but rather arises from courts' general powers of equity and its authority under Section 105(a) of the Bankruptcy Code. The remedy does not require a finding of fraud or intent to hinder or delay creditors, but rather requires a determination that consolidation would be more equitable to all parties under the circumstances. If appropriate circumstances are determined to exist, a bankruptcy court may consolidate the assets and liabilities of different entities by merging the assets and liabilities of multiple debtors, or entities affiliated with the debtor, into one debtor's estate, thereby eliminating inter-corporate liabilities of the related entities, and treating the related entities as a single consolidated entity for the purpose of the bankruptcy case.[7]

The U.S. Courts of Appeal for the Second, Third, Ninth, Eleventh and District of Columbia Circuits have articulated the majority standard for the granting of substantive consolidation, although the actual wording of the test varies somewhat. In the Second Circuit, courts consider whether: (a) the creditors dealt with the entities as a single economic unit and did not rely on their separate identities in extending credit; or (b) the affairs of the entities are so entangled that consolidation will benefit all creditors because disentangling is either impossible or prohibitively expensive. *In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515 (2d Cir. 1988)*. The Ninth Circuit follows the *Augie/Restivo* formulation. *In re Bonham*, 229 F.3d 750 (9th Cir. 2000). In the Eleventh Circuit and the District of Columbia Circuit, the proponent must show: (a) a substantial identity between the entities to be consolidated; and (b) that consolidation is necessary to avoid some harm or to realize some benefit. *In re Southern Motel Assoc., Ltd., 935 F.2d 245 (11th Cir. 1991); In re Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987)*. Other federal circuits have variations on these formulations, while several have not enunciated any controlling test for substantive consolidation.

In 2005, the Third Circuit issued its significant reformulation of the substantive

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[6] Substantive consolidation should not be confused with the "joint administration" of bankruptcy cases pursuant to Rule 1015 of the Federal Rules of Bankruptcy Procedure. Substantive consolidation combines assets and liabilities of multiple entities, while joint administration involves the procedural administration of multiple related bankruptcy cases in accordance with the Federal Rules of Bankruptcy Procedure for convenience and efficiency.

[7] There is disagreement in the courts about whether a debtor may be consolidated with a non-debtor. *In re Mihranian*, 937 F.3d 1214, 1216 (9th Cir. 2019) (permitting such consolidation); *In re Archdiocese of St. Paul & Minneapolis*, 888 F.3d 944 (8th Cir. 2018) (rejecting such consolidation).

consolidation test in *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005), cert. denied, 547 U.S. 1123 (2006). After canvassing the existing law of substantive consolidation, the Third Circuit determined that, absent the consent of all parties, substantive consolidation of the affected entities may be granted if "(i) prepetition [those entities] disregarded separateness so significantly [that] their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and would hurt all creditors." *Id*.

14.4.1. IN RE OWENS CORNING, 419 F.3d 195 (3d Cir. 2005)

We consider under what circumstances a court exercising bankruptcy powers may substantively consolidate affiliated entities. Appellant Credit Suisse First Boston ("CSFB") is the agent for a syndicate of banks (collectively, the "Banks") that extended in 1997 a $2 billion unsecured loan to Owens Corning, a Delaware corporation ("OCD"), and certain of its subsidiaries. This credit was enhanced in part by guarantees made by other OCD subsidiaries. The District Court granted a motion to consolidate the assets and liabilities of the OCD borrowers and guarantors in anticipation of a plan of reorganization.

While this area of law is difficult and this case important, its outcome is easy with the facts before us. Among other problems, the consolidation sought is "deemed." Should we approve this non-consensual arrangement, the plan process would proceed as though assets and liabilities of separate entities were merged, but in fact they remain separate with the twist that the guarantees to the Banks are eliminated. From this we conclude that the proponents of substantive consolidation request it not to rectify the seldom-seen situations that call for this last-resort remedy but rather as a ploy to deprive one group of creditors of their rights while providing a windfall to other creditors.

OCD and its subsidiaries (which include corporations and limited liability companies) comprise a multinational corporate group. Different entities within the group have different purposes. Some, for example, exist to limit liability concerns (such as those related to asbestos), others to gain tax benefits, and others have regulatory reasons for their formation.

Each subsidiary was a separate legal entity that observed governance formalities. Each had a specific reason to exist separately, each maintained its own business records, and intercompany transactions were regularly documented. Although there may have been some "sloppy" bookkeeping, two of OCD's own officers testified that the financial statements of all the subsidiaries were accurate in all material respects. Further, through an examination of the subsidiaries' books, OCD's postpetition auditors (Ernst & Young) have eliminated most financial discrepancies, particularly with respect to the larger guarantor subsidiaries.

In 1997 OCD sought a loan to acquire Fibreboard Corporation. At this time OCD faced growing asbestos liability and a poor credit rating that hindered its ability to obtain financing. When CSFB was invited to submit a bid, it included subsidiary guarantees in the terms of its proposal. The guarantees gave the Banks direct claims against the guarantors for payment defaults. They were a "credit enhancement" without which the Banks would not have made the loan to OCD. All draft loan term sheets included subsidiary guarantees.

A $2 billion loan from the Banks to OCD closed in June 1997. The loan terms were set out primarily in a Credit Agreement. [Section] 10.8 [of the Credit Agreement] stated that "the obligations of each guarantor . . . shall not be reduced, limited or terminated, nor shall such guarantor be discharged from any such obligations, for any reason whatsoever," except payment and performance in full or through waiver or amendment of the Credit Agreement."

CSFB negotiated the Credit Agreement expressly to limit the ways in which OCD could deal with its subsidiaries. For example, it could not enter into transactions with a subsidiary that would result in losses to that subsidiary. Importantly, the Credit Agreement contained provisions designed to protect the separateness of OCD and its subsidiaries. The subsidiaries agreed explicitly to maintain themselves as separate entities. To further this agreement, they agreed to keep separate books and financial records in order to prepare separate financial statements….

On October 5, 2000, facing mounting asbestos litigation, OCD and seventeen of its subsidiaries (collectively, the "Debtors") filed for reorganization under Chapter 11 of the Bankruptcy Code. Twenty-seven months later, the Debtors and certain unsecured creditor groups (collectively, the "Plan Proponents") proposed a reorganization plan (as amended, the "Plan") predicated on obtaining "substantive consolidation" of the Debtors along with three non-Debtor OCD subsidiaries. Typically this arrangement pools all assets and liabilities of the subsidiaries into their parent and treats all claims against the subsidiaries as transferred to the parent. In fact, however, the Plan Proponents sought a form of what is known as a "deemed consolidation," under which a consolidation is deemed to exist for purposes of valuing and satisfying creditor claims, voting for or against the Plan, and making distributions for allowed claims under it. Yet "the Plan would not result in the merger of or the transfer or commingling of any assets of any of the Debtors or Non-Debtor Subsidiaries, . . . [which] will continue to be owned by the respective Debtors or Non-Debtors." Despite this, on the Plan's effective date "all guarantees of the Debtors of the obligations of any other Debtor will be deemed eliminated, so that any claim against any such Debtor and any guarantee thereof . . . will be deemed to be one obligation of the Debtors with respect to the consolidated estate." Put another way, "the Plan eliminates the separate obligations of the Subsidiary Debtors arising from the guarant[e]es of the 1997 Credit Agreement."

The Banks objected to the proposed consolidation…. [The District Court granted the consolidation motion in an order accompanied by a short opinion, concluding] that there existed "substantial identity between OCD and its wholly-owned subsidiaries." He further determined that "there [was] simply no basis for a finding that, in extending credit, the Banks relied upon the separate credit of any of the subsidiary guarantors." In [the District Court's] view, it was "also clear that substantive consolidation would greatly simplify and expedite the successful completion of this entire bankruptcy proceeding. More importantly, it would be exceedingly difficult to untangle the financial affairs of the various entities." As such, he held substantive consolidation should be permitted, as not only did it allow "obvious advantages[, but was] a virtual necessity." In any event, [the District Court] wrote, "[t]he real issue is whether the Banks are entitled to participate, *pari passu*, with other unsecured creditors, or whether the Banks' claim is entitled to priority, in whole or in part, over the claims of other unsecured creditors." But this issue, he stated, "cannot now be determined."

Substantive consolidation exists as an equitable remedy. But when should it be available and by what test should its use be measured? As already noted, we have commented on substantive consolidation only generally in *Nesbit*, 347 F.3d at 86-88, and *In re Genesis Health Ventures*, 402

F.3d at 423-24. The latter nonetheless left little doubt that, if presented with a choice of analytical avenues, we favor essentially that of [the Second Circuit in] *Augie/Restivo*. The *Auto-Train* approach (requiring "substantial identity" of entities to be consolidated, plus that consolidation is "necessary to avoid some harm or realize some benefit," adopts, we presume, one of the *Augie/Restivo* touchstones for substantive consolidation while adding the low bar of avoiding some harm or discerning some benefit by consolidation. To us this fails to capture completely the few times substantive consolidation may be considered and then, when it does hit one chord, it allows a threshold not sufficiently egregious and too imprecise for easy measure. For example, we disagree that "[i]f a creditor makes [a showing of reliance on separateness], the court may order consolidation if it determines that the demonstrated benefits of consolidation `heavily' outweigh the harm." If an objecting creditor relied on the separateness of the entities, consolidation cannot be justified *vis-à-vis* the claims of that creditor.

In assessing whether to order substantive consolidation, courts consider many factors …. They vary (with degrees of overlap) from court to court. Rather than endorsing any prefixed factors, in *Nesbit* we "adopt[ed] an intentionally open-ended, equitable inquiry . . . to determine when substantively to consolidate two entities." While we mentioned that "in the bankruptcy context the inquiry focuses primarily on financial entanglement," *id.*, this comment primarily related to the hopeless commingling test of substantive consolidation. But when creditors deal with entities as an indivisible, single party, "the line between operational and financial [factors] may be blurred." We reiterate that belief here. Too often the factors in a checklist fail to separate the unimportant from the important, or even to set out a standard to make the attempt. This often results in rote following of a form containing factors where courts tally up and spit out a score without an eye on the principles that give the rationale for substantive consolidation (and why, as a result, it should so seldom be in play). "Differing tests with a myriad of factors run the risk that courts will miss the forest for the trees. Running down factors as a check list can lead a court to lose sight of why we have substantive consolidation in the first instance, and often fail [to] identify a metric by which [it] can ... [assess] the relative importance among the factors. The ... [result is] resort to ad hoc balancing without a steady eye on the [principles] to be advanced.").

What, then, are those principles? We perceive them to be as follows.

(1) Limiting the cross-creep of liability by respecting entity separateness is a "fundamental ground rule[]."As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.

(2) The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code (*e.g.*, fraudulent transfers, §§ 548 and 544(b)(1), and equitable subordination, § 510(c)).

(3) Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make postpetition accounting more convenient) is hardly a harm calling substantive consolidation into play.

(4) Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in

any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code).

(5) While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights).

The upshot is this. In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation. The second rationale needs no explanation. The first, however, is more nuanced. A *prima facie* case for it typically exists when, based on the parties' prepetition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity. Proponents who are creditors must also show that, in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity. Creditor opponents of consolidation can nonetheless defeat a *prima facie* showing under the first rationale if they can prove they are adversely affected and actually relied on debtors' separate existence.

With the principles we perceive underlie use of substantive consolidation, the outcome of this appeal is apparent at the outset. Substantive consolidation fails to fit the facts of our case and, in any event, a "deemed" consolidation cuts against the grain of all the principles.

To begin, the Banks did the "deal world" equivalent of "Lending 101." They loaned $2 billion to OCD and enhanced the credit of that unsecured loan indirectly by subsidiary guarantees covering less than half the initial debt. What the Banks got in lending lingo was "structural seniority"—a direct claim against the guarantors (and thus against their assets levied on once a judgment is obtained) that other creditors of OCD did not have. This kind of lending occurs every business day. To undo this bargain is a demanding task.

Despite the Plan Proponents' pleas to the contrary, there is no evidence of the prepetition disregard of the OCD entities' separateness. To the contrary, OCD (no less than CSFB) negotiated the 1997 lending transaction premised on the separateness of all OCD affiliates. Even today no allegation exists of bad faith by anyone concerning the loan. In this context, OCD and the other Plan Proponents cannot now ignore, or have us ignore, the very ground rules OCD put in place. Playing by these rules means that obtaining the guarantees of separate entities, made separate by OCD's choice of how to structure the affairs of its affiliate group of companies, entitles a lender, in bankruptcy or out, to look to any (or all) guarantor(s) for payment when the time comes. As such, the District Court's conclusions of "substantial identity" of OCD and its subsidiaries, and the Banks' reliance thereon, are incorrect. For example, testimony presented by both the Banks and the Debtors makes plain the parties' intention to treat the entities separately. CSFB presented testimony from attorneys and bankers involved in negotiating the Credit Agreement that reflected their assessment of the value of the guarantees as partially derived from the separateness of the entities. As OCD concedes, these representatives "testified that the guarant[e]es were intended to

provide `structural seniority' to the banks," and were thus fundamentally premised on an assumption of separateness.

Even assuming the Plan Proponents could prove prepetition disregard of Debtors' corporate forms, we cannot conceive of a justification for imposing the rule that a creditor must obtain financial statements from a debtor in order to rely reasonably on the separateness of that debtor. Creditors are free to employ whatever metrics they believe appropriate in deciding whether to extend credit free of court oversight. We agree with the Banks that "the reliance inquiry is not an inquiry into lenders' internal credit metrics. Rather, it is about the *fact* that the credit decision was made in reliance on the existence of separate entities." Here there is no serious dispute as to that fact.

There also is no meaningful evidence postpetition of hopeless commingling of Debtors' assets and liabilities. Indeed, there is no question which entity owns which principal assets and has which material liabilities. Likely for this reason little time is spent by the parties on this alternative test for substantive consolidation. It is similarly likely that the District Court followed suit.

The Court nonetheless erred in concluding that the commingling of assets will justify consolidation when "the affairs of the two companies are so entangled that consolidation *will be beneficial."* As we have explained, commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of *every* creditor—that is, when every creditor will benefit from the consolidation. Moreover, the benefit to creditors should be from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another. Mere benefit to some creditors, or administrative benefit to the Court, falls far short. The District Court's test not only fails to adhere to the theoretical justification for "hopeless commingling" consolidation— that no creditor's rights will be impaired— but also suffers from the infirmity that it will almost always be met. That is, substantive consolidation will nearly always produce some benefit to some in the form of simplification and/or avoidance of costs. Among other things, following such a path misapprehends the degree of harm required to order substantive consolidation.

Neither the impossibility of perfection in untangling the affairs of the entities nor the likelihood of some inaccuracies in efforts to do so is sufficient to justify consolidation. We find *In re World Access, Inc.*, 301 B.R. 217 (Bankr. N.D. Ill.2003), instructive on this point. In *World Access* the Court noted that the controlling entity "had no uniform guidelines for the recording of intercompany interest charges" and that the debtors failed to "allocate overhead charges amongst themselves." The Court held, however, that those accounting shortcomings were "merely imperfections in a sophisticated system of accounting records that were conscientiously maintained." It ultimately concluded that "all the relevant accounting data ... still exist[ed]," that only a "reasonable review to make any necessary adjustments [was] required," and, thus, that substantive consolidation was not warranted.

The record in our case compels the same conclusion. At its core, Debtors' argument amounts to the contention that because intercompany interest and royalty payments were not perfectly accounted for, untangling the finances of those entities is a hopeless endeavor. Yet imperfection in intercompany accounting is assuredly not atypical in large, complex company structures. For obvious reasons, we are loathe to entertain the argument that complex corporate families should have an expanded substantive consolidation option in bankruptcy. And we find no

reason to doubt that "perfection is not the standard in the substantive consolidation context." We are confident that a court could properly order and oversee an accounting process that would sufficiently account for the interest and royalty payments owed among the OCD group of companies for purposes of evaluating intercompany claims—dealing with inaccuracies and difficulties as they arise and not in hypothetical abstractions.

Other considerations drawn from the principles we set out also counsel strongly against consolidation. First of all, holding out the possibility of later giving priority to the Banks on their claims does not cure an improvident grant of substantive consolidation. Among other things, the prerequisites for this last-resort remedy must still be met no matter the priority of the Banks' claims.

Secondly, substantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan negotiation process (for example, by deeming assets redistributed to negate plan voting rights), nor a "free pass" to spare Debtors or any other group from proving challenges, like fraudulent transfer claims, that are liberally brandished to scare yet are hard to show. If the Banks are so vulnerable to the fraudulent transfer challenges Debtors have teed up (but have not swung at for so long), then the game should be played to the finish in that arena.

But perhaps the flaw most fatal to the Plan Proponents' proposal is that the consolidation sought was "deemed" (*i.e.,* a pretend consolidation for all but the Banks). If Debtors' corporate and financial structure was such a sham before the filing of the motion to consolidate, then how is it that post the Plan's effective date this structure stays largely undisturbed, with the Debtors reaping all the liability-limiting, tax and regulatory benefits achieved by forming subsidiaries in the first place? In effect, the Plan Proponents seek to remake substantive consolidation not as a remedy, but rather a stratagem to "deem" separate resources reallocated to OCD to strip the Banks of rights under the Bankruptcy Code, favor other creditors, and yet trump possible Plan objections by the Banks. Such "deemed" schemes we deem not Hoyle.

We thus reverse and remand this case to the District Court.

Appendix A. <u>The Fair Debt Collection Practices Act</u>

15 U.S.C. 1601 et seq

[Note: bolding has been added to the original text.]

[T]he Consumer Credit Protection Act (15 U.S.C. 1601 et seq.) is amended by adding at the end thereof the following new title:

§ 801. Short Title [15 USC 1601 note] This title may be cited as the "Fair Debt Collection Practices Act."

§ 802. Congressional findings and declarations of purpose [15 USC 1692] [omitted]

§ 803. Definitions [15 USC 1692a]. As used in this title --

(1) The term "Commission" means the Federal Trade Commission.

(2) The term "communication" means the conveying of information regarding a debt directly or indirectly to any person through any medium.

(3) The term "consumer" means any natural person obligated or allegedly obligated to pay any debt.

(4) The term "creditor" means any person who offers or extends credit creating a debt or to whom a debt is owed, but such term **does not include any person** to the extent that he **receives an assignment or transfer of a debt in default** solely for the purpose of facilitating collection of such debt for another.

(5) The term "debt" means any obligation or alleged **obligation of a consumer to pay money** arising out of a transaction in which the money, property, insurance or services which are the subject of the transaction are **primarily for personal, family, or household purposes**, whether or not such obligation has been reduced to judgment.

(6) The term "debt collector" means any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another. Notwithstanding the exclusion provided by clause (F) of the last sentence of this paragraph, the term includes any creditor who, in the process of collecting his own debts, uses any name other than his own which would indicate that a third person is collecting or attempting to collect such debts. For the purpose of section 808(6), such term also includes any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the enforcement of security interests. The term does not include --

(A) any officer or employee of a creditor while, in the name of the creditor, collecting debts for such creditor;

[Omitted captive debt collectors, government collectors, process servers; credit counselors, escrow agents and secured parties, and debts assigned when not in default]

(7) The term "location information" means a consumer's place of abode and his telephone number at such place, or his place of employment.

§ 804. Acquisition of location information [15 USC 1692b]. Any debt collector **communicating with any person other than the consumer** for the purpose of acquiring location information about the consumer shall --

(1) identify himself, state that he is confirming or correcting location information concerning the consumer, and, only if expressly requested, identify his employer;

(2) not state that such consumer owes any debt;

[other limitations on communications that would lead the contacted person to believe the communication is from a debt collector]

(6) after the debt collector knows the **consumer is represented by an attorney** with regard to the subject debt and has knowledge of, or can readily ascertain, such attorney's name and address, not communicate with any person other than that attorney, **unless the attorney fails to respond** within a reasonable period of time to the communication from the debt collector.

§ 805. Communication in connection with debt collection [15 USC 1692c]

(a) COMMUNICATION WITH THE CONSUMER GENERALLY. Without the prior consent of the consumer given directly to the debt collector or the express permission of a court of competent jurisdiction, a debt collector may **not communicate with a consumer** in connection with the collection of any debt --

(1) at any **unusual time or place** or a time or place known or which should be known to be inconvenient to the consumer. In the absence of knowledge of circumstances to the contrary, a debt collector shall assume that the convenient time for communicating with a consumer is after 8 o'clock antemeridian and before 9 o'clock postmeridian, local time at the consumer's location;

(2) if the debt collector knows the consumer is **represented by an attorney** with respect to such debt and has knowledge of, or can readily ascertain, such attorney's name and address, unless the attorney fails to respond within a reasonable period of time to a communication from the debt collector or unless the attorney consents to direct communication with the consumer; or

(3) at the consumer's place of employment if the debt collector knows or has reason to know that the **consumer's employer** prohibits the consumer from receiving such communication.

(b) COMMUNICATION WITH THIRD PARTIES. **Except as provided in section 804, without the prior consent of the consumer** given directly to the debt collector, or the express permission of a court of competent jurisdiction, or as reasonably necessary to effectuate a post judgment judicial remedy, a **debt collector may not communicate**, in connection with the collection of any debt, with **any person other than a consumer, his attorney**, a consumer reporting agency if otherwise permitted by law, the creditor, the attorney of the creditor, or the attorney of the debt collector.

(c) CEASING COMMUNICATION. If a **consumer notifies a debt collector in <u>writing</u> that the consumer refuses to pay a debt** or that the consumer wishes the debt collector to cease further communication with the consumer, the **debt collector shall not communicate** further with the consumer with respect to such debt, except--

(1) to advise the consumer that the debt collector's further efforts are being terminated;

(2) to notify the consumer that the debt collector or creditor **may invoke specified remedies** which are ordinarily invoked by such debt collector or creditor; or

(3) where applicable, to notify the consumer that the debt collector or creditor intends to invoke a specified remedy.

If such notice from the consumer is made by mail, notification shall be complete upon receipt.

(d) For the purpose of this section, the term "consumer" includes the consumer's spouse, parent (if the consumer is a minor), guardian, executor, or administrator.

§ 806. Harassment or abuse [15 USC 1692d]. A debt collector **may not engage in any conduct** the natural consequence of which is **to harass, oppress, or abuse** any person in connection with the collection of a debt. Without limiting the general application of the foregoing, the following conduct is a violation of this section:

(1) The use or threat of use of violence or other criminal means to harm the physical person, reputation, or property of any person.

(2) The use of obscene or profane language or language the natural consequence of which is to abuse the hearer or reader.

(3) The publication of a list of consumers who allegedly refuse to pay debts, except to a consumer reporting agency or to persons meeting the requirements of section 603(f) or 604(3)1 of this Act.

(4) The advertisement for sale of any debt to coerce payment of the debt.

(5) Causing a telephone to ring or engaging any person in telephone conversation repeatedly or continuously with intent to annoy, abuse, or harass any person at the called number.

(6) Except as provided in section 804, the placement of telephone calls without meaningful disclosure of the caller's identity.

§ 807. False or misleading representations [15 USC 1692e]. A debt collector may not use any **false, deceptive, or misleading** representation or means in connection with the collection of any debt. Without limiting the general application of the foregoing, the following conduct is a violation of this section:

(1) The false representation or implication that the debt collector is vouched for, bonded by, or affiliated with the **United States or any State**, including the use of any badge, uniform, or facsimile thereof.

(2) The false representation of --

(A) the character, amount, or legal status of any debt; or

(B) any services rendered or compensation which may be lawfully received by any debt collector for the collection of a debt.

(3) The **false** representation or implication that any individual is an **attorney** or that any communication is from an attorney.

(4) The representation or implication that **nonpayment of any debt will result in the arrest or imprisonment** of any person or the seizure, garnishment, attachment, or sale of any property or wages of any person unless such action is lawful and the debt collector or creditor intends to take such action.

(5) The threat to take any action that cannot legally be taken or that is not intended to be taken.

(6) The false representation or implication that a sale, referral, or other transfer of any interest in a debt shall cause the consumer to --

(A) lose any claim or defense to payment of the debt; or

(B) become subject to any practice prohibited by this title.

(7) The false representation or implication that the consumer committed any crime or other conduct in order to disgrace the consumer.

(8) Communicating or threatening to communicate to any person **credit information** which is known or which should be known to be false, including the failure to communicate that a disputed debt is disputed.

(9) The use or distribution of any written communication which simulates or is falsely represented to be a document authorized, issued, or approved by any court, official, or agency of the United States or any State, or which creates a false impression as to its source, authorization, or approval.

(10) The use of any false representation or deceptive means to collect or attempt to collect any debt or to obtain information concerning a consumer.

(11) The failure to disclose in the **initial written communication** with the consumer and, in addition, if the initial communication with the consumer is oral, in that initial oral communication, that the debt collector is **attempting to collect a debt** and that **any information obtained will be used for that purpose**, and the failure to disclose in subsequent communications that the communication is from a debt collector, except that this paragraph shall not apply to a formal pleading made in connection with a legal action.

(12) The false representation or implication that accounts have been turned over to innocent purchasers for value.

(13) The false representation or implication that documents are legal process.

(14) The use of any business, company, or organization name other than the true name of the debt collector's business, company, or organization.

(15) The false representation or implication that documents are not legal process forms or do not require action by the consumer.

(16) The false representation or implication that a debt collector operates or is employed by a consumer reporting agency as defined by section 603(f) of this Act.

§ 808. Unfair practices [15 USC 1692f]. A debt collector **may not use unfair or unconscionable means** to collect or attempt to collect any debt. Without limiting the general application of the foregoing, the following conduct is a violation of this section:

(1) The **collection of any amount** (including any interest, fee, charge, or expense incidental to the principal obligation) unless such amount is **expressly authorized** by the agreement creating the debt **or permitted** by law.

(2) The acceptance by a debt collector from any person of a check or other payment instrument **postdated by more than five days** unless such person is notified in writing of the debt collector's intent to deposit such check or instrument not more than ten nor less than three business days prior to such deposit.

(3) The solicitation by a debt collector of any postdated check or other postdated payment instrument for the purpose of threatening or instituting criminal prosecution.

(4) Depositing or threatening to deposit any postdated check or other postdated payment instrument prior to the date on such check or instrument.

(5) Causing charges to be made to any person for communications by concealment of the true purpose of the communication. Such charges include, but are not limited to, **collect telephone calls** and telegram fees.

(6) Taking or threatening to take any non-judicial action to effect dispossession or disablement of property if --

(A) there is no present right to possession of the property claimed as collateral through an enforceable security interest;

(B) there is no present intention to take possession of the property; or

(C) the property is exempt by law from such dispossession or disablement.

(7) Communicating with a consumer regarding a debt by post card.

(8) Using any language or symbol, other than the debt collector's address, on any envelope when communicating with a consumer by use of the mails or by telegram, except that a debt collector may use his business name if such name does not indicate that he is in the debt collection business.

§ 809. Validation of debts [15 USC 1692g]

(a) **Within five days after the initial communication** with a consumer in connection with the collection of any debt, a debt collector shall, unless the following information is contained in the initial communication or the consumer has paid the debt, **send the consumer a written notice containing** --

(1) the amount of the debt;

(2) the name of the creditor to whom the debt is owed;

(3) a statement that unless the consumer, within thirty days after receipt of the notice, disputes the validity of the debt, or any portion thereof, the debt will be assumed to be valid by the debt collector;

(4) a statement that if the consumer notifies the debt collector in writing within the thirty-day period that the debt, or any portion thereof, is disputed, the debt collector will obtain verification of the debt or a copy of a judgment against the consumer and a copy of such verification or judgment will be mailed to the consumer by the debt collector; and

(5) a statement that, upon the consumer's written request within the thirty-day period, the debt collector will provide the consumer with the name and address of the original creditor, if different from the current creditor.

(b) If the consumer notifies the debt collector in writing within the thirty-day period described in subsection (a) that the debt, or any portion thereof, is disputed, or that the consumer requests the name and address of the original creditor, the **debt collector shall cease collection** of the debt, or any disputed portion thereof, **until the debt collector obtains verification** of the debt or any copy of a judgment, or the name and address of the original creditor, **and a copy of such verification or judgment, or name and address of the original creditor, is mailed to the consumer by the debt collector**.

(c) The failure of a consumer to dispute the validity of a debt under this section may not be construed by any court as an admission of liability by the consumer.

§ 810. Multiple debts [15 USC 1692h]. If any consumer owes multiple debts and makes any single payment to any debt collector with respect to such debts, such debt collector **may not apply such payment to any debt which is disputed** by the consumer **and**, where applicable, **shall apply such payment in accordance with the consumer's directions**.

§ 811. Legal actions by debt collectors [15 USC 1692i]

(a) Any debt collector who brings any legal action on a debt against any consumer shall --

(1) in the case of an action to enforce an interest in real property securing the consumer's obligation, bring such action only in a judicial district or similar legal entity in which such **real property is located**; or

(2) in the case of an action not described in paragraph (1), bring such action only in the judicial district or similar legal entity --

(A) in which such consumer signed the contract sued upon; or

(B) in which such consumer resides at the commencement of the action.

(b) Nothing in this title shall be construed to authorize the bringing of legal actions by debt collectors.

§ 812. Furnishing certain deceptive forms [15 USC 1692j]

(a) It is unlawful to design, compile, and furnish any form knowing that such form would be used to create the false belief in a consumer that a person other than the creditor of such consumer is participating in the collection of or in an attempt to collect a debt such consumer allegedly owes such creditor, when in fact such person is not so participating.

(b) Any person who violates this section shall be liable to the same extent and in the same manner as a debt collector is liable under section 813 for failure to comply with a provision of this title.

§ 813. Civil liability [15 USC 1692k]

(a) Except as otherwise provided by this section, any debt collector who fails to comply with any provision of this title with respect to any person is liable to such person in an amount equal to the sum of --

(1) any actual damage sustained by such person as a result of such failure;

(2)

(A) in the case of any action by an individual, such additional damages as the court may allow, but not exceeding $1,000; or

(B) in the case of a class action, (i) such amount for each named plaintiff as could be recovered under subparagraph (A), and (ii) such amount as the court may allow for all other class members, without regard to a minimum individual recovery, not to exceed the lesser of $500,000 or 1 per centum of the net worth of the debt collector; and

(3) in the case of any successful action to enforce the foregoing liability, **the costs of the action, together with a reasonable attorney's fee as determined by the court**. On a finding by the court that an action under this section was brought in bad faith and for the purpose of harassment, the court may award to the defendant attorney's fees reasonable in relation to the work expended and costs.

(b) In determining the amount of liability in any action under subsection (a), the court shall consider, among other relevant factors --

(1) in any individual action under subsection (a)(2)(A), the frequency and persistence of noncompliance by the debt collector, the nature of such noncompliance, and the extent to which such noncompliance was intentional; or

(2) in any class action under subsection (a)(2)(B), the frequency and persistence of noncompliance by the debt collector, the nature of such noncompliance, the resources of the debt collector, the number of persons adversely affected, and the extent to which the debt collector's noncompliance was intentional.

(c) A debt collector may not be held liable in any action brought under this title if the debt collector shows by a preponderance of evidence that the **violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error**.

(d) An action to enforce any liability created by this title may be brought in any appropriate United States district court without regard to the amount in controversy, or in any other court of competent jurisdiction, within one year from the date on which the violation occurs.

(e) No provision of this section imposing any liability shall apply to any act done or omitted in good faith in conformity with any advisory opinion of the Commission, notwithstanding that after such act or omission has occurred, such opinion is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.

§ 814. Administrative enforcement [15 USC 1692l] [omitted]

§ 815. Reports to Congress by the Commission [15 USC 1692m] [omitted]

§ 816. Relation to State laws [15 USC 1692n]. This title does not annul, alter, or affect, or exempt any person subject to the provisions of this title from complying with the laws of any State with respect to debt collection practices, except to the extent that those laws are inconsistent with any provision of this title, and then only to the extent of the inconsistency. For purposes of this section, a **State law is not inconsistent with this title if the protection such law affords any consumer is greater** than the protection provided by this title.

§ 817. Exemption for State regulation [15 USC 1692o]. The Commission shall by regulation exempt from the requirements of this title any class of debt collection practices within any State if the Commission determines that under the law of that State that class of debt collection practices is subject to requirements substantially similar to those imposed by this title, and that there is adequate provision for enforcement.

Appendix B. Federal Wage Garnishment Limits

15 U.S.C. § 1672. Definitions. For the purposes of this subchapter:

(a) The term "earnings" means compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise, and includes periodic payments pursuant to a pension or retirement program.

(b) The term "disposable earnings" means that part of the earnings of any individual remaining after the deduction from those earnings of any amounts required by law to be withheld.

(c) The term "garnishment" means any legal or equitable procedure through which the earnings of any individual are required to be withheld for payment of any debt.

15 U.S.C. 1673. Restriction on garnishment.

(a) Maximum allowable garnishment. Except as provided in subsection (b) of this section and in section 1675 of this title, the maximum part of the aggregate disposable earnings of an individual for any workweek which is subjected to garnishment may not exceed

(1) 25 per centum of his disposable earnings for that week, or

(2) the amount by which his disposable earnings for that week exceed thirty times the Federal minimum hourly wage prescribed by section 206 (a)(1) of title 29 in effect at the time the earnings are payable,

whichever is less. In the case of earnings for any pay period other than a week, the Secretary of Labor shall by regulation prescribe a multiple of the Federal minimum hourly wage equivalent in effect to that set forth in paragraph (2).

(b) Exceptions

(1) The restrictions of subsection (a) of this section do not apply in the case of

(A) any order for the support of any person issued by a court of competent jurisdiction or in accordance with an administrative procedure, which is established by State law, which affords substantial due process, and which is subject to judicial review.

(B) any order of any court of the United States having jurisdiction over cases under chapter 13 of title 11.

(C) any debt due for any State or Federal tax.

(2) The maximum part of the aggregate disposable earnings of an individual for any workweek which is subject to garnishment to enforce any order for the support of any person shall not exceed—

(A) where such individual is supporting his spouse or dependent child (other than a spouse or child with respect to whose support

such order is used), 50 per centum of such individual's disposable earnings for that week; and

(B) where such individual is not supporting such a spouse or dependent child described in clause (A), 60 per centum of such individual's disposable earnings for that week; except that, with respect to the disposable earnings of any individual for any workweek, the 50 per centum specified in clause (A) shall be deemed to be 55 per centum and the 60 per centum specified in clause (B) shall be deemed to be 65 per centum, if and to the extent that such earnings are subject to garnishment to enforce a support order with respect to a period which is prior to the twelve-week period which ends with the beginning of such workweek.

(c) Execution or enforcement of garnishment order or process prohibited. No court of the United States or any State, and no State (or officer or agency thereof), may make, execute, or enforce any order or process in violation of this section.

15 U.S. Code § 1674 - Restriction on discharge from employment by reason of garnishment.

(a) Termination of employment. No employer may discharge any employee by reason of the fact that his earnings have been subjected to garnishment for any one indebtedness.

(b) Penalties. Whoever willfully violates subsection (a) of this section shall be fined not more than $1,000, or imprisoned not more than one year, or both.

15 U.S. Code § 1677 - Effect on State laws. This subchapter does not annul, alter, or affect, or exempt any person from complying with, the laws of any State.

(1) prohibiting garnishments or providing for more limited garnishment than are allowed under this subchapter, or

(2) prohibiting the discharge of any employee by reason of the fact that his earnings have been subjected to garnishment for more than one indebtedness.

Appendix C. New York Exemptions

C.1. CPLR § 5201. Debt or property subject to enforcement; proper garnishee.

a) Debt against which a money judgment may be enforced. A money judgment may be enforced against any debt, which is past due or which is yet to become due, certainly or upon demand of the judgment debtor, whether it was incurred within or without the state, to or from a resident or non-resident, unless it is exempt from application to the satisfaction of the judgment. A debt may consist of a cause of action which could be assigned or transferred accruing within or without the state.

(b) Property against which a money judgment may be enforced. A money judgment may be enforced against any property which could be assigned or transferred, whether it consists of a present or future right or interest and whether or not it is vested, unless it is exempt from application to the satisfaction of the judgment. A money judgment entered upon a joint liability of two or more persons may be enforced against individual property of those persons summoned and joint property of such persons with any other persons against whom the judgment is entered.

(c) Proper garnishee for particular property or debt

1. Where property consists of a right or share in the stock of an association or corporation, or interests or profits therein, for which a certificate of stock or other negotiable instrument is not outstanding, the corporation, or the president or treasurer of the association on behalf of the association, shall be the garnishee.

2. Where property consists of a right or interest to or in a decedent's estate or any other property or fund held or controlled by a fiduciary, the executor or trustee under the will, administrator or other fiduciary shall be the garnishee.

3. Where property consists of an interest in a partnership, any partner other than the judgment debtor, on behalf of the partnership, shall be the garnishee.

4. Where property or a debt is evidenced by a negotiable instrument for the payment of money, a negotiable document of title or a certificate of stock of an association or corporation, the instrument, document or certificate shall be treated as property capable of delivery and the person holding it shall be the garnishee; except that section 8-112 of the uniform commercial code shall govern the extent to which and the means by which any interest in a certificated security, uncertificated security or security entitlement (as defined in article eight of the uniform commercial code) may be reached by garnishment, attachment or other legal process.

C.2. CPLR § 5202. Judgment creditor's rights in personal property.

(a) Execution creditor's rights. Where a judgment creditor has delivered an execution to a sheriff, the judgment creditor's rights in a debt owed to the judgment debtor or in an interest of the judgment debtor in personal property, against which debt or property the judgment may be enforced, are superior to the extent of the amount of the execution to the rights of any transferee of the debt or property, except:

1. a transferee who acquired the debt or property for fair consideration before it was levied upon; or

2. a transferee who acquired a debt or personal property not capable of delivery for fair consideration after it was levied upon without knowledge of the levy.

(b) Other judgment creditor's rights. Where a judgment creditor has secured an order for delivery of, payment of, or appointment of a receiver of, a debt owed to the judgment debtor or an interest of the judgment debtor in personal property, the judgment creditor's rights in the debt or property are superior to the rights of any transferee of the debt or property, except a transferee who acquired the debt or property for fair consideration and without notice of such order.

C.3. CPLR § 5203. Priorities and liens upon real property.

(a) Priority and lien on docketing judgment. No transfer of an interest of the judgment debtor in real property, against which property a money judgment may be enforced, is effective against the judgment creditor either from the time of the docketing of the judgment with the clerk of the county in which the property is located until ten years after filing of the judgment-roll, or from the time of the filing with such clerk of a notice of levy pursuant to an execution until the execution is returned, except:

1. a transfer or the payment of the proceeds of a judicial sale, which shall include an execution sale, in satisfaction either of a judgment previously so docketed or of a judgment where a notice of levy pursuant to an execution thereon was previously so filed; or

2. a transfer in satisfaction of a mortgage given to secure the payment of the purchase price of the judgment debtor's interest in the property; or

3. a transfer to a purchaser for value at a judicial sale, which shall include an execution sale; or

4. when the judgment was entered after the death of the judgment debtor; or

5. when the judgment debtor is the state, an officer, department, board or commission of the state, or a municipal corporation; or

6. when the judgment debtor is the personal representative of a decedent and the judgment was awarded in an action against him in his representative capacity.

(b) Extension of lien. Upon motion of the judgment creditor, upon notice to the judgment debtor, served personally or by registered or certified mail, return receipt requested, to the last known address of the judgment debtor, the court may order that the lien of a money judgment upon real property be effective after the expiration of ten years from the filing of the judgment-roll, for a period no longer than the time during which the judgment creditor was stayed from enforcing the judgment, or the time necessary to complete advertisement and sale of real property in accordance with section 5236 , pursuant to an execution delivered to a sheriff prior to the expiration of ten years from the filing of the judgment-roll. The order shall be effective from the time it is filed with the

clerk of the county in which the property is located and an appropriate entry is made upon the docket of the judgment.

(c) Notwithstanding any other provision of law, where a court makes an oral or written determination on the record awarding ownership of an interest in real property, and a judgment effectuating such determination is docketed with the clerk of the county in which such property is located not later than thirty days thereafter, such judgement shall be deemed entered and docketed on the day immediately preceding the date of such determination solely for purposes of establishing the priority thereof against a judicial lien on such property created upon the simultaneous or later filing of a petition in bankruptcy pursuant to the United States bankruptcy code, as amended.

C.4 CPLR § 5205. Personal property exempt from application to the satisfaction of money judgments.

(a) Exemption for personal property. The following personal property when owned by any person is exempt from application to the satisfaction of a money judgment except where the judgment is for the purchase price of the exempt property or was recovered by a domestic, laboring person or mechanic for work performed by that person in such capacity:

1. all stoves and home heating equipment kept for use in the judgment debtor's dwelling house and necessary fuel therefor for one hundred twenty days; one sewing machine with its appurtenances;

2. religious texts, family pictures and portraits, and school books used by the judgment debtor or in the family; and other books, not exceeding five hundred dollars in value, kept and used as part of the family or judgment debtor's library;

3. a seat or pew occupied by the judgment debtor or the family in a place of public worship;

4. domestic animals with the necessary food for those animals for one hundred twenty days, provided that the total value of such animals and food does not exceed one thousand dollars; all necessary food actually provided for the use of the judgment debtor or his family for one hundred twenty days;

5. all wearing apparel, household furniture, one mechanical, gas or electric refrigerator, one radio receiver, one television set, one computer and associated equipment, one cellphone, crockery, tableware and cooking utensils necessary for the judgment debtor and the family; all prescribed health aids;

6. a wedding ring; a watch, jewelry and art not exceeding one thousand dollars in value;

7. tools of trade, necessary working tools and implements, including those of a mechanic, farm machinery, team, professional instruments, furniture and library, not exceeding three thousand dollars in value, together with the necessary food for the team for one hundred twenty days, provided, however, that the articles specified in this paragraph are necessary to the carrying on of the judgment debtor's profession or calling;

8. one motor vehicle not exceeding four thousand dollars in value above liens and encumbrances of the debtor; if such vehicle has been equipped for use by a disabled debtor, then ten thousand dollars in value above liens and encumbrances of the debtor; provided, however, that this exemption for one motor vehicle shall not apply if the debt enforced is for child support, spousal support, maintenance, alimony or equitable distribution; and

9. if no homestead exemption is claimed, then one thousand dollars in personal property, bank account or cash.

* * *

(g) Security deposit exemption. Money deposited as security for the rental of real property to be used as the residence of the judgment debtor or the judgment debtor's family; and money deposited as security with a gas, electric, water, steam, telegraph or telephone corporation, or a municipality rendering equivalent utility services, for services to judgment debtor's residence or the residence of judgment debtor's family, are exempt from application to the satisfaction of a money judgment

C.5. CPLR § 5206. Real property exempt from application to the satisfaction of money judgments.

(a) Exemption of homestead. Property of one of the following types, not exceeding [$150,000 in NYC counties, $125,000 in certain other expensive counties, and $75,000 in the remaining counties like Onondaga] in value above liens and encumbrances, owned and occupied as a principal residence, is exempt from application to the satisfaction of a money judgment, unless the judgment was recovered wholly for the purchase price thereof:

1. a lot of land with a dwelling thereon,

2. shares of stock in a cooperative apartment corporation,

3. units of a condominium apartment, or

4. a mobile home.

But no exempt homestead shall be exempt from taxation or from sale for non-payment of taxes or assessments.

(b) Homestead exemption after owner's death. The homestead exemption continues after the death of the person in whose favor the property was exempted for the benefit of the surviving spouse and surviving children until the majority of the youngest surviving child and until the death of the surviving spouse.

(c) Suspension of occupation as affecting homestead. The homestead exemption ceases if the property ceases to be occupied as a residence by a person for whose benefit it may so continue, except where the suspension of occupation is for a period not exceeding one year, and occurs in consequence of injury to, or destruction of, the dwelling house upon the premises.

(d) Exemption of homestead exceeding [exempt amounts by county listed above]. The exemption of a homestead is not void because the value of the property exceeds [the exempt amount by county] but the lien of a judgment attaches to the surplus.

(e) Sale of homestead exceeding [exempt amounts by county listed above]. A judgment creditor may commence a special proceeding in the county in which the homestead is located against the judgment debtor for the sale, by a sheriff or receiver, of a homestead exceeding [exempt amount by county]. The court may direct that the notice of petition be served upon any other person. The court, if it directs such a sale, shall so marshal the proceeds of the sale that the right and interest of each person in the proceeds shall correspond as nearly as may be to his right and interest in the property sold. Money, not exceeding [exempt amounts by county] paid to a judgment debtor, as representing his interest in the proceeds, is exempt for one year after the payment, unless, before the expiration of the year, he acquires an exempt homestead, in which case, the exemption ceases with respect to so much of the money as was not expended for the purchase of that property; and the exemption of the property so acquired extends to every debt against which the property sold was exempt. Where the exemption of property sold as prescribed in this subdivision has been continued after the judgment debtor's death, or where he dies after the sale and before payment to him of his portion of the proceeds of the sale, the court may direct that portion of the proceeds which represents his interest be invested for the benefit of the person or persons entitled to the benefit of the exemption, or be otherwise disposed of as justice requires.

(f) Exemption of burying ground. Land, set apart as a family or private burying ground, is exempt from application to the satisfaction of a money judgment, upon the following conditions only:

1. a portion of it must have been actually used for that purpose;

2. it must not exceed in extent one-fourth of an acre; and

3. it must not contain any building or structure, except one or more vaults or other places of deposit for the dead, or mortuary monuments.

C.6. New York Debtor Creditor Law, Art. 10A, § 282.

Under section five hundred twenty-two of title eleven of the United States Code , entitled “Bankruptcy”, an individual debtor domiciled in this state may exempt from the property of the estate, to the extent permitted by subsection (b) thereof, only (i) personal and real property exempt from application to the satisfaction of money judgments under sections fifty-two hundred five and fifty-two hundred six of the civil practice law and rules, (ii) insurance policies and annuity contracts and the proceeds and avails thereof as provided in section three thousand two hundred twelve of the insurance law and (iii) the following property:

1. Bankruptcy exemption of a motor vehicle. One motor vehicle not exceeding **four thousand dollars** in value above liens and encumbrances of the debtor; provided, however, if such vehicle has been equipped for use by a disabled debtor, then ten thousand dollars in value above liens and encumbrances of the debtor.

2. Bankruptcy exemption for right to receive benefits. The debtor's right to receive or the debtor's interest in: (a) a social security benefit, unemployment compensation or a local public assistance benefit; (b) a veterans' benefit; (c) a disability, illness, or unemployment benefit; (d) alimony, support, or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor; and (e) all payments under a stock bonus, pension, profit sharing, or similar plan or contract on account of illness, disability, death, age, or length of service unless (i) such plan or contract, except those qualified under section 401 , 408 or 408A of the United States Internal Revenue Code of 1986 , 1 as amended, was established by the debtor or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose, (ii) such plan is on account of age or length of service, and (iii) such plan or contract does not qualify under section four hundred one (a) , four hundred three (a) , four hundred three (b) , four hundred eight , four hundred eight A, four hundred nine or four hundred fifty-seven of the Internal Revenue Code of nineteen hundred eighty-six , 2 as amended.

3. Bankruptcy exemption for right to receive certain property. The debtor's right to receive, or property that is traceable to: (i) an award under a crime victim's reparation law; (ii) a payment on account of the wrongful death of an individual of whom the debtor was a dependent to the extent reasonably necessary for the support of the debtor and any dependent of the debtor; (iii) a payment, not to exceed seventy-five hundred dollars on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent; and (iv) a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor.

C.7. New York Debtor Creditor Law, Art. 10A, § 283.

Aggregate individual bankruptcy exemption for certain annuities and personal property.

1. General application. The aggregate amount the debtor may exempt from the property of the estate **for personal property** exempt from application to the satisfaction of a money judgment under subdivision (a) of section fifty-two hundred five of the civil practice law and rules and for benefits, rights, privileges, and options of annuity contracts described in the following sentence **shall not exceed ten thousand dollars**. Annuity contracts subject to the foregoing limitation are those that are: (a) initially purchased by the debtor within six months of the debtor's filing a petition in bankruptcy, (b) not described in any paragraph of section eight hundred five (d) of the Internal Revenue Code of nineteen hundred fifty-four, and (c) not purchased by application of proceeds under settlement options of annuity contracts purchased more than six months before the debtor's filing a petition in bankruptcy or under settlement options of life insurance policies.

2. Contingent alternative bankruptcy exemption. Notwithstanding section two hundred eighty-two of this article, a debtor, who (a) does not elect, claim, or otherwise avail himself of an exemption described in section fifty-two hundred six of the civil practice law and rules; (b) utilizes to the fullest extent permitted by law as applied to said debtor's property, the exemptions referred to in subdivision one of this section which are subject to the ten thousand dollar aggregate limit; and (c) does not reach such aggregate limit, **may exempt cash in the amount by which ten thousand dollars exceeds the aggregate of his or her exemptions** referred to in subdivision one of this section **or in the amount of five thousand dollars, whichever amount is less**. For purposes of this subdivision, cash means currency of the United States at face value, savings bonds of the United States at face value, the right to receive a refund of federal, state and local income taxes, and deposit accounts in any state or federally chartered depository institution.

C.8. New York Debtor Creditor Law, Art. 10A, § 284 [OLD].

Exclusivity of exemptions.

In accordance with the provisions of section five hundred twenty-two (b) of title eleven of the United States Code, debtors domiciled in this state are not authorized to exempt from the estate property that is specified under subsection (d) of such section.

C.9. New York Debtor Creditor Law, Art. 10A, § 285 [NEW].

Alternative federal exemptions.

Notwithstanding any inconsistent provision of law, an individual debtor may opt to exempt from property of the estate such property as is permitted to be exempted pursuant to section five hundred twenty-two of title eleven of the United States Code in lieu of such property as is permitted to be exempted pursuant to the applicable provisions of this article.

Appendix D. Social Security Act § 207, 42 U.S.C. § 407

(a) The right of any person to any future payment under this title shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this title shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.

(b) No other provision of law, enacted before, on, or after the date of the enactment of this section, may be construed to limit, supersede, or otherwise modify the provisions of this section except to the extent that it does so by express reference to this section.

(c) Nothing in this section shall be construed to prohibit withholding taxes from any benefit under this title, if such withholding is done pursuant to a request made in accordance with section 3402(p)(1) of the Internal Revenue Code of 1986 by the person entitled to such benefit or such person's representative payee

Appendix E. New York Uniform Voidable Transactions Act (NY-UVTA), N.Y. Debt. & Cred. Law §§ 270-281 (effective April 4, 2020)

NYUVTA Index

Section 270 – Definitions

As used in this article:

(a) "Affiliate" means:

(1) a person that directly or indirectly owns, controls or holds with power to vote, twenty percent or more of the outstanding voting securities of the debtor, other than a person that holds the securities:

(i) as a fiduciary or agent without sole discretionary power to vote the securities; or

(ii) solely to secure a debt, if the person has not in fact exercised the power to vote;

(2) a corporation twenty percent or more of whose outstanding voting securities are directly or indirectly owned, controlled or held with power to vote, by the debtor or a person that directly or indirectly owns, controls or holds, with power to vote, twenty percent or more of the outstanding voting securities of the debtor, other than a person that holds the securities:

(i) as a fiduciary or agent without sole discretionary power to vote the securities; or

(ii) solely to secure a debt, if the person has not in fact exercised the power to vote;

(3) a person whose business is operated by the debtor under a lease or other agreement, or a person substantially all of whose assets are controlled by the debtor; or

(4) a person that operates the debtor's business under a lease or other agreement or controls substantially all of the debtor's assets.

(b) "Asset" means property of a debtor, but the term does not include:

(1) property to the extent it is encumbered by a valid lien;

(2) property to the extent it is generally exempt under non-bankruptcy law; or

(3) an interest in property held in tenancy by the entirety to the extent it is not subject to process by a creditor holding a claim against only one tenant.

(c) "Claim", except as used in "claim for relief", means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.

(d) "Creditor" means a person that has a claim.

(e) "Debt" means liability on a claim.

(f) "Debtor" means a person that is liable on a claim.

(g) "Electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic or similar capabilities.

(h) "Insider" includes:

(1) if the debtor is an individual:

(i) a relative of the debtor or of a general partner of the debtor;

(ii) a partnership in which the debtor is a general partner;

(iii) a general partner in a partnership described in subparagraph (ii) of this paragraph; or

(iv) a corporation of which the debtor is a director, officer, or person in control;

(2) if the debtor is a corporation:

(i) a director of the debtor;

(ii) an officer of the debtor;

(iii) a person in control of the debtor;

(iv) a partnership in which the debtor is a general partner;

(v) a general partner in a partnership described in subparagraph (iv) of this paragraph; or

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

(3) if the debtor is a partnership:

(i) a general partner in the debtor;

(ii) a relative of a general partner in, a general partner of or a person in control of the debtor;

(iii) another partnership in which the debtor is a general partner;

(iv) a general partner in a partnership described in subparagraph (iii) of this paragraph; or

(v) a person in control of the debtor;

(4) an affiliate, or an insider of an affiliate as if the affiliate were the debtor; and

(5) a managing agent of the debtor.

(i) "Lien" means a charge against or an interest in property to secure payment of a debt or performance of an obligation, and includes a security interest created by agreement, a judicial lien obtained by legal or equitable process or proceedings, a common-law lien, or a statutory lien.

(j) "Organization" means a person other than an individual.

(k) "Person" means an individual, estate, partnership, association, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency or instrumentality, or other legal or commercial entity.

(l) "Property" means anything that may be the subject of ownership.

(m) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(n) "Relative" means an individual related by consanguinity within the third degree as determined by the common law, a spouse or an individual related to a spouse within the third degree as so determined, and includes an individual in an adoptive relationship within the third degree.

(o) "Sign" means, with present intent to authenticate or adopt a record:

(i) to execute or adopt a tangible symbol; or

(ii) to attach to or logically associate with the record an electronic symbol, sound, or process.

(p) "Transfer" means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, license, and creation of a lien or other encumbrance.

(q) "Valid lien" means a lien that is effective against the holder of a judicial lien subsequently obtained by legal or equitable process or proceedings.

Section 271 - Insolvency

(a) A debtor is insolvent if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets.

(b) A debtor that is generally not paying the debtor's debts as they become due other than as a result of a bona fide dispute is presumed to be insolvent. The presumption imposes on the party against which the presumption is directed the burden of proving that the nonexistence of insolvency is more probable than its existence.

(c) Assets under this section do not include property that has been transferred, concealed or removed with intent to hinder, delay or defraud creditors, or that has been transferred in a manner making the transfer voidable under this article.

(d) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

Section 272 - Value

(a) Value is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person.

(b) For the purposes of paragraph two of subdivision (a) of section two hundred seventy-three and section two hundred seventy-four of this article, a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement.

(c) A transfer is made for present value if the exchange between the debtor and the transferee is intended by them to be contemporaneous and is in fact substantially contemporaneous.

Section 273 - Transfer or obligation voidable as to present or future creditor

(a) A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) with actual intent to hinder, delay or defraud any creditor of the debtor; or

(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

(b) In determining actual intent under paragraph one of subdivision (a) of this section, consideration may be given, among other factors, to whether:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets;

(6) the debtor absconded;

(7) the debtor removed or concealed assets;

(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor.

(c) A creditor making a claim for relief under subdivision (a) of this section has the burden of proving the elements of the claim for relief by a preponderance of the evidence.

Section 274 - Transfer or obligation voidable as to present creditor

(a) A transfer made or obligation incurred by a debtor is voidable as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

(b) A transfer made by a debtor is voidable as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.

(c) Subject to subdivision (b) of section two hundred seventy-one of this article, a creditor making a claim for relief under subdivision (a) or (b) of this section has the burden of proving the elements of the claim for relief by a preponderance of the evidence.

Section 275 - When transfer is made or obligation is incurred

For the purposes of this article:

(a) a transfer is made:

(1) with respect to an asset that is real property other than a fixture, but including the interest of a seller or purchaser under a contract for the sale of the asset, when the

transfer is so far perfected that a good-faith purchaser of the asset from the debtor against which applicable law permits the transfer to be perfected cannot acquire an interest in the asset that is superior to the interest of the transferee; and

(2) with respect to an asset that is not real property or that is a fixture, when the transfer is so far perfected that a creditor on a simple contract cannot acquire a judicial lien otherwise than under this article that is superior to the interest of the transferee;

(b) if applicable law permits the transfer to be perfected as provided in subdivision (a) of this section and the transfer is not so perfected before the commencement of an action for relief under this article, the transfer is deemed made immediately before the commencement of the action;

(c) if applicable law does not permit the transfer to be perfected as provided in subdivision (a) of this section, the transfer is made when it becomes effective between the debtor and the transferee;

(d) a transfer is not made until the debtor has acquired rights in the asset transferred; and

(e) an obligation is incurred:

(1) if oral, when it becomes effective between the parties; or

(2) if evidenced by a record, when the record signed by the obligor is delivered to or for the benefit of the obligee.

Section 276 - Remedies of creditor

(a) In an action for relief against a transfer or obligation under this article, a creditor, subject to the limitations in section two hundred seventy-seven of this article, may obtain:

(1) avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim;

(2) an attachment or other provisional remedy against the asset transferred or other property of the transferee if available under applicable law; and

(3) subject to applicable principles of equity and in accordance with applicable rules of civil procedure:

(i) an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property;

(ii) appointment of a receiver to take charge of the asset transferred or of other property of the transferee; or

(iii) any other relief the circumstances may require.

(b) If a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset transferred or its proceeds.

Section 276-A - Attorney's fees in action or special proceeding under this article to avoid a transfer or obligation

In an action or special proceeding under this article in which a judgment creditor who has been awarded by court order or agreement or has waived attorney's fees available to prevailing parties by the terms of the statute under which the creditor's underlying claim arose, or representative asserting the rights of such judgment creditor, recovers judgment avoiding any transfer or obligation, the justice or surrogate presiding at the trial shall fix the reasonable attorney's fees of the creditor, or creditor representative, incurred in such action or special proceeding under this article as an additional amount required to satisfy the creditor's claim, and the creditor, or creditor representative, shall have judgment therefor against the debtor and, subject to the defenses and protections in section two hundred seventy-seven of this article, against any transferee (or person for whose benefit the transfer was made) against whom relief is ordered, in addition to the other relief granted by the judgment. The fee so fixed shall be without regard, or prejudice, to any agreement, express or implied, between the creditor, or the creditor representative, and his or her attorney with respect to the compensation of such attorney.

Section 277 - Defenses, liability, and protection of transferee or obligee

(a) A transfer or obligation is not voidable under paragraph one of subdivision (a) of section two hundred seventy-three of this article against a person that took in good faith and for a reasonably equivalent value given the debtor or against any subsequent transferee or obligee.

(b) To the extent a transfer is avoidable in an action by a creditor under paragraph one of subdivision (a) of section two hundred seventy-six of this article the following rules apply:

(1) Except as otherwise provided in this section, the creditor may recover judgment for the value of the asset transferred, as adjusted under subdivision (c) of this section, or the amount necessary to satisfy the creditor's claim, whichever is less. The judgment may be entered against:

(i) the first transferee of the asset or the person for whose benefit the transfer was made; or

(ii) an immediate or mediate transferee of the first transferee, other than:

(A) a good-faith transferee that took for value; or

(B) an immediate or mediate good-faith transferee of a person described in clause (A) of this subparagraph.

(2) Recovery pursuant to paragraph one of subdivision (a) or subdivision (b) of section two hundred seventy-six of this article of or from the asset transferred or its proceeds, by levy or otherwise, is available only against a person described in subparagraph (i) or (ii) of paragraph one of this subdivision.

(c) If the judgment under subdivision (b) of this section is based upon the value of the asset transferred, the judgment must be for an amount equal to the value of the asset at the time of the transfer, subject to adjustment as the equities may require.

(d) Notwithstanding voidability of a transfer or an obligation under this article, a good-faith transferee or obligee is entitled, to the extent of the value given the debtor for the transfer or obligation, to:

(1) a lien on or a right to retain an interest in the asset transferred;

(2) enforcement of an obligation incurred; or

(3) a reduction in the amount of the liability on the judgment.

(e) A transfer is not voidable under paragraph two of subdivision (a) of section two hundred seventy-three or section two hundred seventy-four of this article if the transfer results from:

(1) termination of a lease upon default by the debtor when the termination is pursuant to the lease and applicable law; or

(2) enforcement of a security interest in compliance with article nine of the uniform commercial code, other than acceptance of collateral in full or partial satisfaction of the obligation it secures.

(f) A transfer is not voidable under subdivision (b) of section two hundred seventy-four of this article:

(1) to the extent the insider gave new value to or for the benefit of the debtor after the transfer was made, except to the extent the new value was secured by a valid lien;

(2) if made in the ordinary course of business or financial affairs of the debtor and the insider; or

(3) if made pursuant to a good-faith effort to rehabilitate the debtor and the transfer secured present value given for that purpose as well as an antecedent debt of the debtor.

(g) The following rules determine the burden of proving matters referred to in this section:

(1) A party that seeks to invoke subdivision (a), (d), (e) or (f) of this section has the burden of proving the applicability of that subdivision.

(2) Except as otherwise provided in paragraphs three and four of this subdivision, the creditor has the burden of proving each applicable element of subdivision (b) or (c) of this section.

(3) The transferee has the burden of proving the applicability to the transferee of clause (A) or (B) of subparagraph (ii) of paragraph one of subdivision (b) of this section.

(4) A party that seeks adjustment under subdivision (c) of this section has the burden of proving the adjustment.

(h) The standard of proof required to establish matters referred to in this section is preponderance of the evidence.

Section 278 - Extinguishment of claim for relief

A claim for relief with respect to a transfer or obligation under this article is extinguished unless action is brought:

(a) under paragraph one of subdivision (a) of section two hundred seventy-three of this article, not later than four years after the transfer was made or the obligation was incurred or, if later, not later than one year after the transfer or obligation was or could reasonably have been discovered by the claimant;

(b) under paragraph two of subdivision (a) of section two hundred seventy-three or subdivision (a) of section two hundred seventy-four of this article, not later than four years after the transfer was made or the obligation was incurred; or

(c) under subdivision (b) of section two hundred seventy-four of this article, not later than one year after the transfer was made.

Section 279 - Governing law

(a) In this section, the following rules determine a debtor's location:

(1) A debtor who is an individual is located at the individual's principal residence.

(2) A debtor that is an organization and has only one place of business been located at its place of business.

(3) A debtor that is an organization and has more than one place of business is located at its chief executive office.

(b) A claim for relief in the nature of a claim for relief under this article is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred.

Section 280 - Supplementary provisions

Unless displaced by the provisions of this article, the principles of law and equity, including the law merchant and the law relating to principal and agent, estoppel, laches, fraud, misrepresentation, duress, coercion, mistake, insolvency, or other validating or invalidating cause, supplement its provisions.

Section 281 - Uniformity of application and construction

This article shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this article among states enacting it.

Appendix F. Article 9 of the New York Uniform Commercial Code

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F.1. Index

Part 6 - DEFAULT

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F.2. Statutory Provisions

New York Article 9 – SECURED TRANSACTIONS

Part 1 – GENERAL PROVISIONS

SubPart 1 - SHORT TITLE, DEFINITIONS, AND GENERAL CONCEPTS

Section 9-101. Short Title.

This article may be cited as Uniform Commercial Code—Secured Transactions.

Section 9-102. Definitions and Index of Definitions.

(a) Article 9 definitions. In this article:

(1) "Accession" means goods that are physically united with other goods in such a manner that the identity of the original goods is not lost.

(2) "Account", except as used in "account for", means a right to payment of a monetary obligation, whether or not earned by performance,

(i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of,

(ii) for services rendered or to be rendered,

(iii) for a policy of insurance issued or to be issued,

(iv) for a secondary obligation incurred or to be incurred,

(v) for energy provided or to be provided,

(vi) for the use or hire of a vessel under a charter or other contract,

(vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or

(viii) as winnings in a lottery or other game of chance operated or sponsored by a state, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes health-care-insurance receivables.

The term does not include

(i) rights to payment evidenced by chattel paper or an instrument,

(ii) commercial tort claims,

(iii) deposit accounts,

(iv) investment property,

(v) letter-of-credit rights or letters of credit, or

(vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

(3) "Account debtor" means a person obligated on an account, chattel paper, or general intangible. The term does not include persons obligated to pay a negotiable instrument, even if the instrument constitutes part of chattel paper.

(4) "Accounting", except as used in "accounting for", means a record:

(A) authenticated by a secured party;

(B) indicating the aggregate unpaid secured obligations as of a date not more than 35 days earlier or 35 days later than the date of the record; and

(C) identifying the components of the obligations in reasonable detail.

(5) "Agricultural lien" means an interest in farm products:

(A) which secures payment or performance of an obligation for:

(i) goods or services furnished in connection with a debtor's farming operation; or

(ii) rent on real property leased by a debtor in connection with its farming operation; and

(B) which is created by statute in favor of a person that:

(i) in the ordinary course of its business furnished goods or services to a debtor in connection with a debtor's farming operation; or

(ii) leased real property to a debtor in connection with the debtor's farming operation; and

(C) whose effectiveness does not depend on the person's possession of the personal property.

(6) "As-extracted collateral" means:

(A) oil, gas, or other minerals that are subject to a security interest that:

(i) is created by a debtor having an interest in the minerals before extraction; and

(ii) attaches to the minerals as extracted; or

(B) accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor had an interest before extraction.

(7) "Authenticate" means:

(A) to sign; or

(B) with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process.

(8) "Bank" means an organization that is engaged in the business of banking. The term includes savings banks, savings and loan associations, credit unions, and trust companies.

(9) "Cash proceeds" means proceeds that are money, checks, deposit accounts, or the like.

(10) "Certificate of title" means a certificate of title with respect to which a statute provides for the security interest in question to be indicated on the certificate as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral. Such term includes another record maintained as an alternative to a certificate of title by the governmental unit that issues certificates of title if a statute permits the security interest in question to be indicated on the record as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral.

(11) "Chattel paper" means a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. In this paragraph, "monetary obligation" means a monetary obligation

secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods. The term does not include

(i) charters or other contracts involving the use or hire of a vessel or

(ii) records that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.

(11-a) "Check" means

(i) a draft, other than a documentary draft, payable on demand and drawn on a bank or

(ii) a cashier's check or a teller's check. An instrument may be a check even though it is described on its face by another term, such as "money order". An instrument that

(i) meets all of the requirements stated in Article 3 of this chapter to be a negotiable instrument other than stating that it is payable to order or bearer and

(ii) otherwise qualifies as a check is a negotiable instrument and a check.

(12) "Collateral" means the property subject to a security interest or agricultural lien. The term includes:

(A) proceeds to which a security interest attaches;

(B) accounts, chattel paper, payment intangibles, and promissory notes that have been sold; and

(C) goods that are the subject of a consignment.

(13) "Commercial tort claim" means a claim arising in tort with respect to which:

(A) the claimant is an organization; or

(B) the claimant is an individual and the claim: (i) arose in the course of the claimant's business or profession; and (ii) does not include damages arising out of personal injury to or the death of an individual.

(14) "Commodity account" means an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer.

(15) "Commodity contract" means a commodity futures contract, an option on a commodity futures contract, a commodity option, or another contract if the contract or option is:

(A) traded on or subject to the rules of a board of trade that has been designated as a contract market for such a contract pursuant to federal commodities laws; or

(B) traded on a foreign commodity board of trade, exchange, or market, and is carried on the books of a commodity intermediary for a commodity customer.

(16) "Commodity customer" means a person for which a commodity intermediary carries a commodity contract on its books.

(17) "Commodity intermediary" means a person that:

(A) is registered as a futures commission merchant under federal commodities law; or

(B) in the ordinary course of its business provides clearance or settlement services for a board of trade that has been designated as a contract market pursuant to federal commodities law.

(18) "Communicate" means:

(A) to send a written or other tangible record;

(B) to transmit a record by any means agreed upon by the persons sending and receiving the record; or

(C) in the case of transmission of a record to or by a filing office, to transmit a record by any means prescribed by filing-office rule.

(19) "Consignee" means a merchant to which goods are delivered in a consignment.

(20) "Consignment" means a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:

(A) the merchant:

(i) deals in goods of that kind under a name other than the name of the person making delivery;

(ii) is not an auctioneer; and

(iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;

(B) with respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery;

(C) the goods are not consumer goods immediately before delivery; and

(D) the transaction does not create a security interest that secures an obligation.

(21) "Consignor" means a person that delivers goods to a consignee in a consignment.

(22) "Consumer debtor" means a debtor in a consumer transaction.

(23) "Consumer goods" means goods that are used or bought for use primarily for personal, family, or household purposes.

(24) "Consumer-goods transaction" means a consumer transaction in which:

(A) an individual incurs an obligation primarily for personal, family, or household purposes; and

(B) a security interest in consumer goods secures the obligation.

(25) "Consumer obligor" means an obligor who is an individual and who incurred the obligation as part of a transaction entered into primarily for personal, family, or household purposes.

(26) "Consumer transaction" means a transaction in which

(i) an individual incurs an obligation primarily for personal, family, or household purposes,

(ii) a security interest secures the obligation, and

(iii) the collateral is held or acquired primarily for personal, family, or household purposes. The term includes consumer-goods transactions.

(27) "Continuation statement" means an amendment of a financing statement which:

(A) identifies, by its file number, the initial financing statement to which it relates; and

(B) indicates that it is a continuation statement for, or that it is filed to continue the effectiveness of, the identified financing statement.

(27-a) "Cooperative addendum" means a record that satisfies Section 9-502(e).

(27-b) "Cooperative interest" means an ownership interest in a cooperative organization, which interest, when created, is coupled with possessory rights of a proprietary nature in identified physical space belonging to the cooperative organization. A subsequent termination of the possessory rights shall not cause an ownership interest to cease being a cooperative interest.

(27-c) "Cooperative organization" means an organization which has as its principal asset an interest in real property in this state and in which organization all ownership interests are cooperative interests.

(27-d) "Cooperative organization security interest" means a security interest which is in a cooperative interest, is in favor of the cooperative organization, is created by the cooperative record, and secures only obligations incident to ownership of that cooperative interest.

(27-e) "Cooperative record" means those records which, as a whole, evidence cooperative interests and define the mutual rights and obligations of the owners of the cooperative interests and the cooperative organization.

(27-f) "Cooperative unit" means the physical space associated with a cooperative interest.

(28) "Debtor" means:

(A) a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor;

(B) a seller of accounts, chattel paper, payment intangibles, or promissory notes; or

(C) a consignee.

(29) "Deposit account" means a demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument.

(30) "Document" means a document of title or a receipt of the type described in Section 7-201(b).

(31) "Electronic chattel paper" means chattel paper evidenced by a record or records consisting of information stored in an electronic medium.

(32) "Encumbrance" means a right, other than an ownership interest, in real property. The term includes mortgages and other liens on real property.

(33) "Equipment" means goods other than inventory, farm products, or consumer goods.

(34) "Farm products" means goods, other than standing timber, with respect to which the debtor is engaged in a farming operation and which are:

(A) crops grown, growing, or to be grown, including:

(i) crops produced on trees, vines, and bushes; and

(ii) aquatic goods produced in aquacultural operations;

(B) livestock, born or unborn, including aquatic goods produced in aquacultural operations;

(C) supplies used or produced in a farming operation; or

(D) products of crops or livestock in their unmanufactured states.

(35) "Farming operation" means raising, cultivating, propagating, fattening, grazing, or any other farming, livestock, or aquacultural operation.

(36) "File number" means the number assigned to an initial financing statement pursuant to Section 9-519(a).

(37) "Filing office" means an office designated in Section 9-501 as the place to file a financing statement.

(38) "Filing-office rule" means a rule adopted pursuant to Section 9-526.

(39) "Financing statement" means a record or records composed of an initial financing statement and any filed record relating to the initial financing statement.

(40) "Fixture filing" means the filing of a financing statement covering goods that are or are to become fixtures and satisfying Section 9-502(a) and (b). The term includes the filing of a financing statement covering goods of a transmitting utility which are or are to become fixtures.

(41) "Fixtures" means goods that have become so related to particular real property that an interest in them arises under real property law.

(42) "General intangible" means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.

(43) "Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing.

(44) "Goods" means all things that are movable when a security interest attaches. The term includes

(i) fixtures,

(ii) standing timber that is to be cut and removed under a conveyance or contract for sale,

(iii) the unborn young of animals,

(iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and

(v) manufactured homes.

The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if

(i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or

(ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consists solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.

(45) "Governmental unit" means a subdivision, agency, department, county, parish, municipality, or other unit of the government of the United States, a state, or a foreign country. The term includes an organization having a separate corporate existence if the organization is eligible to issue debt on which interest is exempt from income taxation under the laws of the United States.

(46) "Health-care-insurance receivable" means an interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided or to be provided.

(47) "Instrument" means a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment. The term does not include

(i) investment property,

(ii) letters of credit, or

(iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card.

(48) "Inventory" means goods, other than farm products, which:

(A) are leased by a person as lessor;

(B) are held by a person for sale or lease or to be furnished under a contract of service;

(C) are furnished by a person under a contract of service; or

(D) consist of raw materials, work in process, or materials used or consumed in a business.

(49) "Investment property" means a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.

(50) "Jurisdiction of organization", with respect to a registered organization, means the jurisdiction under whose law the organization is formed or organized.

(51) "Letter-of-credit right" means a right to payment or performance under a letter of credit, whether or not the beneficiary has demanded or is at the time entitled to demand payment or performance. The term does not include the right of a beneficiary to demand payment or performance under a letter of credit.

(52) "Lien creditor" means:

(A) a creditor that has acquired a lien on the property involved by attachment, levy, or the like;

(B) an assignee for benefit of creditors from the time of assignment;

(C) a trustee in bankruptcy from the date of the filing of the petition; or

(D) a receiver in equity from the time of appointment.

(53) "Manufactured home" means a structure, transportable in one or more sections, which, in the traveling mode, is eight body feet or more in width or 40 body feet or more in length, or, when erected on site, is 320 or more square feet, and which is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air-conditioning, and electrical systems contained therein. The term includes any structure that meets all of the requirements of this paragraph except the size requirements and with respect to which the manufacturer voluntarily files a certification required by the United States Secretary of Housing and Urban Development and complies with the standards established under Title 42 of the United States Code.

(54) "Manufactured-home transaction" means a secured transaction:

(A) that creates a purchase-money security interest in a manufactured home, other than a manufactured home held as inventory; or

(B) in which a manufactured home, other than a manufactured home held as inventory, is the primary collateral.

(55) "Mortgage" means a consensual interest in real property, including fixtures, which secures payment or performance of an obligation.

(56) "New debtor" means a person that becomes bound as debtor under Section 9-203(d) by a security agreement previously entered into by another person.

(57) "New value" means

(i) money,

(ii) money's worth in property, services, or new credit, or

(iii) release by a transferee of an interest in property previously transferred to the transferee. The term does not include an obligation substituted for another obligation.

(58) "Noncash proceeds" means proceeds other than cash proceeds.

(59) "Obligor" means a person that, with respect to an obligation secured by a security interest in or an agricultural lien on the collateral,

(i) owes payment or other performance of the obligation,

(ii) has provided property other than the collateral to secure payment or other performance of the obligation, or

(iii) is otherwise accountable in whole or in part for payment or other performance of the obligation. The term does not include issuers or nominated persons under a letter of credit.

(60) "Original debtor", except as used in Section 9-310(c), means a person that, as debtor, entered into a security agreement to which a new debtor has become bound under Section 9-203(d).

(61) "Payment intangible" means a general intangible under which the account debtor's principal obligation is a monetary obligation.

(62) "Person related to", with respect to an individual, means:

(A) the spouse of the individual;

(B) a brother, brother-in-law, sister, or sister-in-law of the individual;

(C) an ancestor or lineal descendant of the individual or the individual's spouse; or

(D) any other relative, by blood or marriage, of the individual or the individual's spouse who shares the same home with the individual.

(63) "Person related to", with respect to an organization, means:

(A) a person directly or indirectly controlling, controlled by, or under common control with the organization;

(B) an officer or director of, or a person performing similar functions with respect to, the organization;

(C) an officer or director of, or a person performing similar functions with respect to, a person described in subparagraph (A);

(D) the spouse of an individual described in subparagraph (A), (B), or (C); or (E) an individual who is related by blood or marriage to an individual described in subparagraph (A), (B), (C), or (D) and shares the same home with the individual.

(64) "Proceeds", except as used in Section 9-609(b), means the following property:

(A) Whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

(65) "Promissory note" means an instrument that evidences a promise to pay a monetary obligation, does not evidence an order to pay, and does not contain an acknowledgment by a bank that the bank has received for deposit a sum of money or funds.

(66) "Proposal" means a record authenticated by a secured party which includes the terms on which the secured party is willing to accept collateral in full or partial satisfaction of the obligation it secures pursuant to Sections 9-620, 9-621, and 9-622.

(66-a) "Prove" with respect to a fact means to meet the burden of establishing the fact (Section 1-201(8)).

(67) "Public-finance transaction" means a secured transaction in connection with which:

(A) debt securities are issued;

(B) all or a portion of the securities issued have an initial stated maturity of at least 20 years; and

(C) the debtor, obligor, secured party, account debtor or other person obligated on collateral, assignor or assignee of a secured obligation, or assignor or assignee of a security interest is a state or a governmental unit of a state.

(68) "Public organic record" means a record that is available to the public for inspection and is:

(A) a record consisting of the record initially filed with or issued by a state or the United States to form or organize an organization and any record filed with or issued by the state or the United States which amends or restates the initial record;

(B) an organic record of a business trust consisting of the record initially filed with a state and any record filed with the state which amends or restates the initial record, if a statute of the state governing business trusts requires that the record be filed with the state; or

(C) a record consisting of legislation enacted by the legislature of a state or the Congress of the United States which forms or organizes an organization, any record amending the legislation, and any record filed with or issued by the state or the United States which amends or restates the name of the organization.

(69) "Pursuant to commitment", with respect to an advance made or other value given by a secured party, means pursuant to the secured party's obligation, whether or not a subsequent event of default or other event not within the secured party's control has relieved or may relieve the secured party from its obligation.

(70) "Record", except as used in "for record", "of record", "record or legal title", and "record owner", means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form.

(71) "Registered organization" means an organization formed or organized solely under the law of a single state or the United States by the filing of a public organic record with, the issuance of a public organic record by, or the enactment of legislation by the state or the United States. The term includes a business trust that is formed or organized under the law of a single state if a statute of the state governing business trusts requires that the business trust's organic record be filed with the state.

(72) "Secondary obligor" means an obligor to the extent that:

(A) the obligor's obligation is secondary; or

(B) the obligor has a right of recourse with respect to an obligation secured by collateral against the debtor, another obligor, or property of either.

(73) "Secured party" means:

(A) a person in whose favor a security interest is created or provided for under a security agreement, whether or not any obligation to be secured is outstanding;

(B) a person that holds an agricultural lien;

(C) a consignor;

(D) a person to which accounts, chattel paper, payment intangibles, or promissory notes have been sold;

(E) a trustee, indenture trustee, agent, collateral agent, or other representative in whose favor a security interest or agricultural lien is created or provided for; or (F) a person that holds a security interest arising under Section 2-401, 2-505, 2-711(3), 2-A-508(5), 4-210, or 5-118.

(74) "Security agreement" means an agreement that creates or provides for a security interest. A cooperative record that provides that the owner of a cooperative interest has an obligation to pay amounts to the cooperative organization incident to ownership of that cooperative interest and which states that the cooperative organization has a direct remedy against that cooperative interest if such amounts are not paid is a security agreement creating a cooperative organization security interest.

(75) "Send", in connection with a record or notification, means:

(A) to deposit in the mail, deliver for transmission, or transmit by any other usual means of communication, with postage or cost of transmission provided for, addressed to any address reasonable under the circumstances; or

(B) to cause the record or notification to be received within the time that it would have been received if properly sent under subparagraph (A).

(76) "Software" means a computer program and any supporting information provided in connection with a transaction relating to the program. The term does not include a computer program that is included in the definition of goods.

(77) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(78) "Supporting obligation" means a letter-of-credit right or secondary obligation that supports the payment or performance of an account, chattel paper, a document, a general intangible, an instrument, or investment property.

(79) "Tangible chattel paper" means chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium.

(80) "Termination statement" means an amendment of a financing statement which:

(A) identifies, by its file number, the initial financing statement to which it relates; and

(B) indicates either that it is a termination statement or that the identified financing statement is no longer effective.

(81) "Transmitting utility" means a person primarily engaged in the business of:

(A) operating a railroad, subway, street railway, or trolley bus;

(B) transmitting communications electrically, electromagnetically, or by light;

(C) transmitting goods by pipeline or sewer; or

(D) transmitting or producing and transmitting electricity, steam, gas, or water.

(b) Definitions in other articles. The following definitions in other articles apply to this article:

"Applicant" Section 5-102.

"Beneficiary" Section 5-102.

"Broker" Section 8-102.

"Certificated security" Section 8-102.

"Clearing corporation" Section 8-102.

"Contract for sale" Section 2-106.

"Control" (with respect to a document Section 7-106. of title)

"Customer" Section 4-104.

"Entitlement holder" Section 8-102.

"Financial asset" Section 8-102.

"Holder in due course" Section 3-302.

"Issuer" (with respect to a letter of credit or letter-of-credit right) Section 5-102.

"Issuer" (with respect to a security) Section 8-201.

"Issuer" (with respect to document of title) Section 7-102.

"Lease" Section 2-A-103.

"Lease agreement" Section 2-A-103.

"Lease contract" Section 2-A-103.

"Leasehold interest" Section 2-A-103.

"Lessee" Section 2-A-103.

"Lessee in ordinary course of business" Section 2-A-103.

"Lessor" Section 2-A-103.

"Lessor's residual interest" Section 2-A-103.

“Letter of credit" Section 5-102.

"Merchant" Section 2-104.

"Negotiable instrument" Section 3-104.

"Nominated person" Section 5-102.

"Note" Section 3-104.

"Proceeds of a letter of credit" Section 5-114.

"Prove" Section 4-A-105.

"Sale" Section 2-106.

"Securities account" Section 8-501.

"Securities intermediary" Section 8-102.

"Security" Section 8-102.

"Security certificate" Section 8-102.

"Security entitlement" Section 8-102.

"Uncertificated security" Section 8-102.

(c) Article 1 definitions and principles. Article 1 contains general definitions and principles of construction and interpretation applicable throughout this article.

Section 9-103: Purchase-money Security Interest; Application of Payments; Burden of Establishing

(a) Definitions. In this section:

(1) "purchase-money collateral" means goods or software that secures a purchase-money obligation incurred with respect to that collateral; and

(2) "purchase-money obligation" means an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used.

(b) Purchase-money security interest in goods. A security interest in goods is a purchase-money security interest:

(1) to the extent that the goods are purchase-money collateral with respect to that security interest;

(2) if the security interest is in inventory that is or was purchase-money collateral, also to the extent that the security interest secures a purchase-money obligation incurred with respect to other inventory in which the secured party holds or held a purchase-money security interest; and

(3) also to the extent that the security interest secures a purchase-money obligation incurred with respect to software in which the secured party holds or held a purchase-money security interest.

(c) Purchase-money security interest in software. A security interest in software is a purchase-money security interest to the extent that the security interest also secures a purchase-money obligation incurred with respect to goods in which the secured party holds or held a purchase-money security interest if:

(1) the debtor acquired its interest in the software in an integrated transaction in which it acquired an interest in the goods; and

(2) the debtor acquired its interest in the software for the principal purpose of using the software in the goods.

(d) Consignor's inventory purchase-money security interest. The security interest of a consignor in goods that are the subject of a consignment is a purchase-money security interest in inventory.

(e) Application of payment in non-consumer-goods transaction. In a transaction other than a consumer-goods transaction, if the extent to which a security interest is a purchase-money security interest depends on the application of a payment to a particular obligation, the payment must be applied:

(1) in accordance with any reasonable method of application to which the parties agree;

(2) in the absence of the parties' agreement to a reasonable method, in accordance with any intention of the obligor manifested at or before the time of payment; or

(3) in the absence of an agreement to a reasonable method and a timely manifestation of the obligor's intention, in the following order: (A) to obligations that are not secured; and (B) if more than one obligation is secured, to obligations secured by purchase-money security interests in the order in which those obligations were incurred.

(f) No loss of status of purchase-money security interest in non-consumer-goods transaction. In a transaction other than a consumer-goods transaction, a purchase-money security interest does not lose its status as such, even if:

(1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;

(2) collateral that is not purchase-money collateral also secures the purchase-money obligation; or

(3) the purchase-money obligation has been renewed, refinanced, consolidated, or restructured.

(g) Burden of proof in non-consumer-goods transaction. In a transaction other than a consumer-goods transaction, a secured party claiming a purchase-money security interest has the burden of establishing the extent to which the security interest is a purchase-money security interest.

(h) Non-consumer-goods transactions; no inference. The limitation of the rules in subsections (e), (f), and (g) to transactions other than consumer-goods transactions is intended to leave to the court the termination of the proper rules in consumer-goods transactions. The court may not infer from that limitation the nature of the proper rule in consumer-goods transactions and may continue to apply established approaches.

Section 9-104: Control of Deposit Account

(a) Requirements for control. A secured party has control of a deposit account if:

(1) the secured party is the bank with which the deposit account is maintained;

(2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or

(3) the secured party becomes the bank's customer with respect to the deposit account.

(b) Debtor's right to direct disposition. A secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

Section 9-105: Control of Electronic Chattel Paper

A secured party has control of electronic chattel paper if the record or records comprising the chattel paper are created, stored, and assigned in such a manner that:

(1) a single authoritative copy of the record or records exists which is unique, identifiable and, except as otherwise provided in paragraphs (4), (5), and (6), unalterable;

(2) the authoritative copy identifies the secured party as the assignee of the record or records;

(3) the authoritative copy is communicated to and maintained by the secured party or its designated custodian;

(4) copies or revisions that add or change an identified assignee of the authoritative copy can be made only with the participation of the secured party;

(5) each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and

(6) any revision of the authoritative copy is readily identifiable as an authorized or unauthorized revision.

Section 9-106: Control of Investment Property

(a) Control under Section 8-106. A person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-106.

(b) Control of commodity contract. A secured party has control of a commodity contract if:

(1) the secured party is the commodity intermediary with which the commodity contract is carried; or

(2) the commodity customer, secured party, and commodity intermediary have agreed that the commodity intermediary will apply any value distributed on account of the commodity contract as directed by the secured party without further consent by the commodity customer.

(c) Effect of control of securities account or commodity account. A secured party having control of all security entitlements or commodity contracts carried in a securities account or commodity account has control over the securities account or commodity account.

Section 9-107: Control of Letter-of-credit Right

A secured party has control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under Section 5-114(c) or otherwise applicable law or practice.

Section 9-108: Sufficiency of Description

(a) Sufficiency of description. Except as otherwise provided in subsections (c), (d), and (e), a description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described.

(b) Examples of reasonable identification. Except as otherwise provided in Section 9-502 and subsection (d), a description of collateral reasonably identifies the collateral if it identifies the collateral by:

(1) specific listing;

(2) category;

(3) except as otherwise provided in subsection (e), a type of collateral defined in this chapter;

(4) quantity;

(5) computational or allocational formula or procedure; or

(6) except as otherwise provided in subsection (c), any other method, if the identity of the collateral is objectively determinable.

(c) Supergeneric description not sufficient. A description of collateral as "all the debtor's assets" or "all the debtor's personal property" or using words of similar import does not reasonably identify the collateral.

(d) Investment property. Except as otherwise provided in subsection (e), a description of a security entitlement, securities account, or commodity account is sufficient if it describes:

(1) the collateral by those terms or as investment property; or

(2) the underlying financial asset or commodity contract.

(e) When description by type insufficient. A description only by type of collateral defined in this chapter is an insufficient description of:

(1) a commercial tort claim;

(2) in a consumer transaction, consumer goods, a security entitlement, a securities account, or a commodity account; or

(3) a cooperative interest.

SubPart 2- APPLICABILITY OF ARTICLE

Section 9-109. Scope.

(a) General scope of article. Except as otherwise provided in subsections (c) and (d), this article applies to:

(1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract;

(2) an agricultural lien;

(3) a sale of accounts, chattel paper, payment intangibles, or promissory notes;

(4) a consignment;

(5) a security interest arising under Section 2-401, 2-505, 2-711(3), or 2-A-508(5), as provided in Section 9-110;

(6) a security interest arising under Section 4-210 or 5-118; and

(7) a security interest in a cooperative interest.

(b) Security interest in secured obligation. The application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply.

(c) Extent to which article does not apply. This article does not apply to the extent that:

(1) a statute, regulation, or treaty of the United States preempts this article;

(2) another statute of this State expressly governs the creation, perfection, priority, or enforcement of a security interest created by this state or a governmental unit of this state;

(3) a statute of another state, a foreign country, or a governmental unit of another state or a foreign country, other than a statute generally applicable to security interests, expressly governs creation, perfection, priority, or enforcement of a security interest created by the state, country, or governmental unit; or

(4) the rights of a transferee beneficiary or nominated person under a letter of credit are independent and superior under Section 5-114.

(d) Inapplicability of article. This article does not apply to:

(1) a landlord's lien, other than an agricultural lien, or a security interest in a cooperative interest;

(2) a lien, other than an agricultural lien, given by statute or other rule of law for services or materials, but Section 9-333 applies with respect to priority of the lien;

(3) an assignment of a claim for wages, salary, or other compensation of an employee;

(4) a sale of accounts, chattel paper, payment intangibles, or promissory notes as part of a sale of the business out of which they arose;

(5) an assignment of accounts, chattel paper, payment intangibles, or promissory notes which is for the purpose of collection only;

(6) an assignment of a right to payment under a contract to an assignee that is also obligated to perform under the contract;

(7) an assignment of a single account, payment intangible, or promissory note to an assignee in full or partial satisfaction of a preexisting indebtedness;

(8) a transfer of an interest in or an assignment of a claim under a policy of insurance or contract for an annuity including a variable annuity other than an assignment by or to a health-care provider of a health-care-insurance receivable and any subsequent assignment of the right to payment, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds;

(9) an assignment of a right represented by a judgment, other than a judgment taken on a right to payment that was collateral;

(10) a right of recoupment or set-off, but:

(A) Section 9-340 applies with respect to the effectiveness of rights of recoupment or set-off against deposit accounts; and

(B) Section 9-404 applies with respect to defenses or claims of an account debtor;

(11) the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder, except to the extent that provision is made for:

(A) liens on real property in Section 9-203 and 9-308;

(B) fixtures in Section 9-334;

(C) fixture filings in Sections 9-501, 9-502, 9-512, 9-516, and 9-519;

(D) security agreements covering personal and real property in Section 9-604; and

(E) security interests in cooperative interests;

(12) an assignment of a claim arising in tort, other than a commercial tort claim, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds; or

(13) an assignment of a deposit account in a consumer transaction, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds.

Section 9-110. Security Interests Arising Under Article 2 or 2-A.

A security interest arising under Section 2-401, 2-505, 2-711(3), or 2-A-508(5) is subject to this article. However, until the debtor obtains possession of the goods:

(1) the security interest is enforceable, even if Section 9-203(b)(3) has not been satisfied;

(2) filing is not required to perfect the security interest;

(3) the rights of the secured party after default by the debtor are governed by Article 2 or 2-A; and

(4) the security interest has priority over a conflicting security interest created by the debtor.

Part 2- EFFECTIVENESS OF SECURITY AGREEMENT; ATTACHMENT OF SECURITY INTEREST; RIGHTS OF PARTIES TO SECURITY AGREEMENT

SubPart 1 - EFFECTIVENESS AND ATTACHMENT

Section 9-201. General Effectiveness of Security Agreement.

(a) General effectiveness. Except as otherwise provided in this chapter, a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.

(b) Applicable consumer laws and other law. A transaction subject to this article is subject to:

(1) any applicable rule of law which establishes a different rule for consumers;

(2) any other statute or regulation of this state which regulates the rates, charges, agreements and practices for loans, credit sales or other extensions of credit;

(3) any consumer protection statute or regulation of this state.

(c) Other applicable law controls. In case of conflict between this article and a rule of law, statute, or regulation described in subsection (b), the rule of law, statute, or regulation controls. Failure to comply with a statute or regulation described in subsection (b) has only the effect the statute or regulation specifies.

(d) Further deference to other applicable law. This article does not:

(1) validate any rate, charge, agreement, or practice that violates a rule of law, statute, or regulation described in subsection (b); or

(2) extend the application of the rule of law, statute, or regulation to a transaction not otherwise subject to it.

Section 9-202. Title to Collateral Immaterial.

Except as otherwise provided with respect to consignments or sales of accounts, chattel paper, payment intangibles, or promissory notes, the provisions of this article with regard to rights and obligations apply whether title to collateral is in the secured party or the debtor.

Section 9-203. Attachment and Enforceability of Security Interest; Proceeds; Supporting Obligations; Formal Requisites.

(a) Attachment. A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.

(b) Enforceability. Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if:

(1) value has been given;

(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and

(3) one of the following conditions is met:

(A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;

(B) the collateral is not a certificated security and is in the possession of the secured party under Section 9—313 pursuant to the debtor's security agreement;

(C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; or

(D) the collateral is deposit accounts, electronic chattel paper, investment property, letter-of-credit rights, or electronic documents, and the secured party has control under Section 7-106, 9-104, 9-105, 9-106, or 9—107 pursuant to the debtor's security agreement.

(c) Other UCC provisions. Subsection (b) is subject to Section 4—210 on the security interest of a collecting bank, Section 5-118 on the security interest of a letter-of-credit issuer or nominated person, Section 9-110 on a security interest arising under Article 2 or 2-A, and Section 9-206 on security interests in investment property.

(d) When a person becomes bound by another person's security agreement. A person becomes bound as debtor by a security agreement entered into by another person if, by operation of law other than this article or by contract:

(1) the security agreement becomes effective to create a security interest in the person's property; or

(2) the person becomes generally obligated for the obligations of the other person, including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person.

(e) Effect of new debtor becoming bound. If a new debtor becomes bound as debtor by a security agreement entered into by another person:

(1) the agreement satisfies subsection (b)(3) with respect to existing or after-acquired property of the new debtor to the extent the property is described in the agreement; and

(2) another agreement is not necessary to make a security interest in the property enforceable.

(f) Proceeds and supporting obligations. The attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9-315 and is also attachment of a security interest in a supporting obligation for the collateral.

(g) Lien securing right to payment. The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien.

(h) Security entitlement carried in securities account. The attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account.

(i) Commodity contracts carried in commodity account. The attachment of a security interest in a commodity account is also attachment of a security interest in the commodity contracts carried in the commodity account.

Section 9-204. After-acquired Property; Future Advances.

(a) After-acquired collateral. Except as otherwise provided in subsection (b), a security agreement may create or provide for a security interest in after-acquired collateral.

(b) When after-acquired property clause not effective. A security interest does not attach under a term constituting an after-acquired property clause to:

(1) consumer goods, other than an accession when given as additional security, unless the debtor acquires rights in them within 10 days after the secured party gives value; or

(2) a commercial tort claim.

(c) Future advances and other value. A security agreement may provide that collateral secures, or that accounts, chattel paper, payment intangibles, or promissory notes are sold in connection with, future advances or other value, whether or not the advances or value are given pursuant to commitment.

Section 9-205. Use or Disposition of Collateral Permissible.

(a) When security interest not invalid or fraudulent. A security interest is not invalid or fraudulent against creditors solely because:

(1) the debtor has the right or ability to:

(A) use, commingle, or dispose of all or part of the collateral, including returned or repossessed goods;

(B) collect, compromise, enforce, or otherwise deal with collateral;

(C) accept the return of collateral or make repossessions; or

(D) use, commingle, or dispose of proceeds; or

(2) the secured party fails to require the debtor to account for proceeds or replace collateral.

(b) Requirements of possession not relaxed. This section does not relax the requirements of possession if attachment, perfection, or enforcement of a security interest depends upon possession of the collateral by the secured party.

Section 9-206. Security Interest Arising in Purchase or Delivery of Financial Asset.

(a) Security interest when person buys through securities intermediary. A security interest in favor of a securities intermediary attaches to a person's security entitlement if:

(1) the person buys a financial asset through the securities intermediary in a transaction in which the person is obligated to pay the purchase price to the securities intermediary at the time of the purchase; and

(2) the securities intermediary credits the financial asset to the buyer's securities account before the buyer pays the securities intermediary.

(b) Security interest secures obligation to pay for financial asset. The security interest described in subsection (a) secures the person's obligation to pay for the financial asset.

(c) Security interest in payment against delivery transaction. A security interest in favor of a person that delivers a certificated security or other financial asset represented by a writing attaches to the security or other financial asset if:

(1) the security or other financial asset:

(A) in the ordinary course of business is transferred by delivery with any necessary indorsement or assignment; and

(B) is delivered under an agreement between persons in the business of dealing with such securities or financial assets; and

(2) the agreement calls for delivery against payment.

(d) Security interest secures obligation to pay for delivery. The security interest described in subsection (c) secures the obligation to make payment for the delivery.

SubPart 2- RIGHTS AND DUTIES

Section 9-207: Rights and Duties of Secured Party Having Possession or Control of Collateral

(a) Duty of care when secured party in possession. Except as otherwise provided in subsection (d), a secured party shall use reasonable care in the custody and preservation of collateral in the secured party's possession. In the case of chattel paper or an instrument, reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.

(b) Expenses, risks, duties, and rights when secured party in possession. Except as otherwise provided in subsection (d), if a secured party has possession of collateral:

(1) reasonable expenses, including the cost of insurance and payment of taxes or other charges, incurred in the custody, preservation, use, or operation of the collateral are chargeable to the debtor and are secured by the collateral;

(2) the risk of accidental loss or damage is on the debtor to the extent of a deficiency in any effective insurance coverage;

(3) the secured party shall keep the collateral identifiable, but fungible collateral may be commingled; and

(4) the secured party may use or operate the collateral:

(A) for the purpose of preserving the collateral or its value;

(B) as permitted by an order of a court having competent jurisdiction; or

(C) except in the case of consumer goods, in the manner and to the extent agreed by the debtor.

(c) Duties and rights when secured party in possession or control. Except as otherwise provided in subsection (d), a secured party having possession of collateral or control of collateral under Section 9-104, 9-105, 9-106, or 9-107:

(1) may hold as additional security any proceeds, except money or funds, received from the collateral;

(2) shall apply money or funds received from the collateral to reduce the secured obligation, unless remitted to the debtor; and

(3) may create a security interest in the collateral.

(d) Buyer of certain rights to payment. If the secured party is a buyer of accounts, chattel paper, payment intangibles, or promissory notes or a consignor:

(1) subsection (a) does not apply unless the secured party is entitled under an agreement:

(A) to charge back uncollected collateral; or

(B) otherwise to full or limited recourse against the debtor or a secondary obligor based on the nonpayment or other default of an account debtor or other obligor on the collateral; and (2) subsections (b) and (c) do not apply.

Section 9-208: Additional Duties of Secured Party Having Control of Collateral

(a) Applicability of section. This section applies to cases in which there is no outstanding secured obligation and the secured party is not committed to make advances, incur obligations, or otherwise give value.

(b) Duties of secured party after receiving demand from debtor. Within 10 days after receiving an authenticated demand by the debtor:

(1) a secured party having control of a deposit account under

Section 9-209: Duties of Secured Party If Account Debtor Has Been Notified of Assignment

(a) Applicability of section. Except as otherwise provided in subsection (c), this section applies if:

(1) there is no outstanding secured obligation; and

(2) the secured party is not committed to make advances, incur obligations, or otherwise give value.

(b) Duties of secured party after receiving demand from debtor. Within 10 days after receiving an authenticated demand by the debtor, a secured party shall send to an account debtor that has received notification of an assignment to the secured party as assignee under Section 9-406(a) an authenticated record that releases the account debtor from any further obligation to the secured party.

(c) Inapplicability to sales. This section does not apply to an assignment constituting the sale of an account, chattel paper, or payment intangible.

Section 9-210: Request for Accounting; Request Regarding List of Collateral or Statement of Account

(a) Definitions in this section:

(1) "Request" means a record of a type described in paragraph (2), (3), or (4).

(2) "Request for an accounting" means a record authenticated by a debtor requesting that the recipient provide an accounting of the unpaid obligations secured by collateral and reasonably identifying the transaction or relationship that is the subject of the request.

(3) "Request regarding a list of collateral" means a record authenticated by a debtor requesting that the recipient approve or correct a list of what the debtor believes to be the collateral securing an obligation and reasonably identifying the transaction or relationship that is the subject of the request.

(4) "Request regarding a statement of account" means a record authenticated by a debtor requesting that the recipient approve or correct a statement indicating what the debtor believes to be the aggregate amount of unpaid obligations secured by collateral as of a specified date and reasonably identifying the transaction or relationship that is the subject of the request.

(b) Duty to respond to requests. Subject to subsections (c), (d), (e), and (f), a secured party, other than a buyer of accounts, chattel paper, payment intangibles, or promissory notes or a consignor, shall comply with a request within 14 days after receipt:

(1) in the case of a request for an accounting, by authenticating and sending to the debtor an accounting; and

(2) in the case of a request regarding a list of collateral or a request regarding a statement of account, by authenticating and sending to the debtor an approval or correction.

(c) Request regarding list of collateral; statement concerning type of collateral. A secured party that claims a security interest in all of a particular type of collateral owned by the debtor may comply with a request regarding a list of collateral by sending to the debtor an authenticated record including a statement to that effect within 14 days after receipt.

(d) Request regarding list of collateral; no interest claimed. A person that receives a request regarding a list of collateral, claims no interest in the collateral when it receives the request, and claimed an interest in the collateral at an earlier time shall comply with the request within 14 days after receipt by sending to the debtor an authenticated record:

(1) disclaiming any interest in the collateral; and

(2) if known to the recipient, providing the name and mailing address of any assignee of or successor to the recipient's interest in the collateral.

(e) Request for accounting or regarding statement of account; no interest in obligation claimed. A person that receives a request for an accounting or a request regarding a statement of account, claims no interest in the obligations when it receives the request, and claimed an interest in the obligations at an earlier time shall comply with the request within 14 days after receipt by sending to the debtor an authenticated record:

(1) disclaiming any interest in the obligations; and

(2) if known to the recipient, providing the name and mailing address of any assignee of or successor to the recipient's interest in the obligations.

(f) Charges for responses. A debtor is entitled without charge to one response to a request under this section during any six-month period. The secured party may require payment of a charge not exceeding $25 for each additional response.

Part 3 – PERFECTION AND PRIORITY

SubPart 1 - LAW GOVERNING PERFECTION AND PRIORITY

Section 9-301: Law Governing Perfection and Priority of Security Interests

Except as otherwise provided in Sections 9-303 through 9-306, the following rules determine the law governing perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral:

(a) Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral.

(b) While collateral is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a possessory security interest in that collateral.

(c) Except as otherwise provided in paragraph (d), while negotiable documents, goods, instruments, money, or tangible chattel paper is located in a jurisdiction, the local law of that jurisdiction governs:

(1) perfection of a security interest in the goods by filing a fixture filing;

(2) perfection of a security interest in timber to be cut; and

(3) the effect of perfection or nonperfection and the priority of a nonpossessory security interest in the collateral.

(d) The local law of the jurisdiction in which the wellhead or minehead is located governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in as-extracted collateral.

(e) When collateral is a cooperative interest, the law of this state governs perfection, the effect of perfection or nonperfection, and the priority of the security interest in such collateral.

Section 9-302: Law Governing Perfection and Priority of Agricultural Liens

While farm products are located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of an agricultural lien on the farm products.

Section 9-303: Law Governing Perfection and Priority of Security Interests in Goods Covered by a Certificate of Title

(a) Applicability of section. This section applies to goods covered by a certificate of title, even if there is no other relationship between the jurisdiction under whose certificate of title the goods are covered and the goods or the debtor.

(b) When goods covered by certificate of title. Goods become covered by a certificate of title when a valid application for the certificate of title and the applicable fee are delivered to the appropriate authority. Goods cease to be covered by a certificate of title at the earlier of the time the certificate of title ceases to be effective under the law of the issuing jurisdiction or the time the goods become covered subsequently by a certificate of title issued by another jurisdiction.

(c) Applicable law. The local law of the jurisdiction under whose certificate of title the goods are covered governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in goods covered by a certificate of title from the time the goods become covered by the certificate of title until the goods cease to be covered by the certificate of title.

Section 9-304: Law Governing Perfection and Priority of Security Interests in Deposit Accounts

(a) Law of bank's jurisdiction governs. The local law of a bank's jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a deposit account maintained with that bank.

(b) Bank's jurisdiction. The following rules determine a bank's jurisdiction for purposes of this part:

(1) If an agreement between the bank and the debtor governing the deposit account expressly provides that a particular jurisdiction is the bank's jurisdiction for purposes of this part, this article, or this chapter, that jurisdiction is the bank's jurisdiction.

(2) If paragraph (1) does not apply and an agreement between the bank and its customer governing the deposit account expressly provides that the agreement is governed by the law of a particular jurisdiction, that jurisdiction is the bank's jurisdiction.

(3) If neither paragraph (1) nor paragraph (2) applies and an agreement between the bank and its customer governing the deposit account expressly provides that the deposit account is maintained at an office in a particular jurisdiction, that jurisdiction is the bank's jurisdiction.

(4) If none of the preceding paragraphs apply, the bank's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the customer's account is located.

(5) If none of the preceding paragraphs apply, the bank's jurisdiction is the jurisdiction in which the chief executive office of the bank is located.

Section 9-305. Law Governing Perfection and Priority of Security Interests in Investment Property.

(a) Governing law: general rules. Except as otherwise provided in subsections (c) and (d), the following rules apply:

(1) While a security certificate is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in the certificated security represented thereby.

(2) The local law of the issuer's jurisdiction as specified in Section 8-110(d) governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in an uncertificated security.

(3) The local law of the securities intermediary's jurisdiction as specified in Section 8-110(e) governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a security entitlement or securities account.

(4) The local law of the commodity intermediary's jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a commodity contract or commodity account.

(b) Commodity intermediary's jurisdiction. The following rules determine a commodity intermediary's jurisdiction for purposes of this part:

(1) If an agreement between the commodity intermediary and commodity customer governing the commodity account expressly provides that a particular jurisdiction is the commodity intermediary's jurisdiction for purposes of this part, this article, or this chapter, that jurisdiction is the commodity intermediary's jurisdiction.

(2) If paragraph (1) does not apply and an agreement between the commodity intermediary and commodity customer governing the commodity account expressly provides that the agreement is governed by the law of a particular jurisdiction, that jurisdiction is the commodity intermediary's jurisdiction.

(3) If neither paragraph (1) nor paragraph (2) applies and an agreement between the commodity intermediary and commodity customer governing the commodity account expressly provides that the commodity account is maintained at an office in a particular jurisdiction, that jurisdiction is the commodity intermediary's jurisdiction.

(4) If none of the preceding paragraphs apply, the commodity intermediary's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the commodity customer's account is located.

(5) If none of the preceding paragraphs apply, the commodity intermediary's jurisdiction is the jurisdiction in which the chief executive office of the commodity intermediary is located.

(c) When perfection governed by law of jurisdiction where debtor located. The local law of the jurisdiction in which the debtor is located governs:

(1) perfection of a security interest in investment property by filing;

(2) automatic perfection of a security interest in investment property created by a broker or securities intermediary; and

(3) automatic perfection of a security interest in a commodity contract or commodity account created by a commodity intermediary.

(d) Cooperative interests. Subsections (a) through (c) do not apply to cooperative interests.

Section 9-306. Law Governing Perfection and Priority of Security Interests in Letter-of-credit Rights.

(a) Governing law: issuer's or nominated person's jurisdiction. Subject to subsection (c), the local law of the issuer's jurisdiction or a nominated person's jurisdiction governs perfection,

the effect of perfection or nonperfection, and the priority of a security interest in a letter-of-credit right if the issuer's jurisdiction or nominated person's jurisdiction is a state.

(b) Issuer's or nominated person's jurisdiction. For purposes of this part, an issuer's jurisdiction or nominated person's jurisdiction is the jurisdiction whose law governs the liability of the issuer or nominated person with respect to the letter-of-credit right as provided in Section 5-116.

(c) When section not applicable. This section does not apply to a security interest that is perfected only under Section 9-308(d).

Section 9-307. Location of Debtor.

(a) "Place of business." In this section, "place of business" means a place where a debtor conducts its affairs. (b) Debtor's location: general rules. Except as otherwise provided in this section, the following rules determine a debtor's location:

(1) A debtor who is an individual is located at the individual's principal residence.

(2) A debtor that is an organization and has only one place of business is located at its place of business.

(3) A debtor that is an organization and has more than one place of business is located at its chief executive office.

(c) Limitation of applicability of subsection (b). Subsection (b) applies only if a debtor's residence, place of business, or chief executive office, as applicable, is located in a jurisdiction whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral. If subsection (b) does not apply, the debtor is located in the District of Columbia.

(d) Continuation of location: cessation of existence, etc. A person that ceases to exist, have a residence, or have a place of business continues to be located in the jurisdiction specified by subsections (b) and (c).

(e) Location of registered organization organized under state law. A registered organization that is organized under the law of a state is located in that state.

(f) Location of registered organization organized under federal law; bank branches and agencies. Except as otherwise provided in subsection (i), a registered organization that is organized under the law of the United States and a branch or agency of a bank that is not organized under the law of the United States or a state are located:

(1) in the state that the law of the United States designates, if the law designates a state of location;

(2) in the state that the registered organization, branch, or agency designates, if the law of the United States authorizes the registered organization, branch, or agency to designate its

state of location, including by designating its main office, home office, or other comparable office; or

(3) in the District of Columbia, if neither paragraph (1) nor paragraph (2) applies.

(g) Continuation of location: change in status of registered organization. A registered organization continues to be located in the jurisdiction specified by subsection (e) or (f) notwithstanding:

(1) the suspension, revocation, forfeiture, or lapse of the registered organization's status as such in its jurisdiction of organization; or

(2) the dissolution, winding up, or cancellation of the existence of the registered organization.

(h) Location of United States. The United States is located in the District of Columbia.

(i) Location of foreign bank branch or agency if licensed in only one state. A branch or agency of a bank that is not organized under the law of the United States or a state is located in the state in which the branch or agency is licensed, if all branches and agencies of the bank are licensed in only one state.

(j) Location of foreign air carrier. A foreign air carrier under the Federal Aviation Act of 1958, as amended, is located at the designated office of the agent upon which service of process may be made on behalf of the carrier.

(k) Section applies only to this part. This section applies only for purposes of this part.

SubPart 2- PERFECTION

Section 9-308. When Security Interest or Agricultural Lien Is Perfected; Continuity of Perfection.

(a) Perfection of security interest. Except as otherwise provided in this section and Section 9-309, a security interest is perfected if it has attached and all of the applicable requirements for perfection in Sections 9-310 through 9-316 have been satisfied. A security interest is perfected when it attaches if the applicable requirements are satisfied before the security interest attaches.

(b) Perfection of agricultural lien. An agricultural lien is perfected if it has become effective and all of the applicable requirements for perfection in Section 9-310 have been satisfied. An agricultural lien is perfected when it becomes effective if the applicable requirements are satisfied before the agricultural lien becomes effective.

(c) Continuous perfection; perfection by different methods. A security interest or agricultural lien is perfected continuously if it is originally perfected by one method under this article and is later perfected by another method under this article, without an intermediate period when it was unperfected.

(d) Supporting obligation. Perfection of a security interest in collateral also perfects a security interest in a supporting obligation for the collateral.

(e) Lien securing right to payment. Perfection of a security interest in a right to payment or performance also perfects a security interest in a security interest, mortgage, or other lien on personal or real property securing the right.

(f) Security entitlement carried in securities account. Perfection of a security interest in a securities account also perfects a security interest in the security entitlements carried in the securities account.

(g) Commodity contract carried in commodity account. Perfection of a security interest in a commodity account also perfects a security interest in the commodity contracts carried in the commodity account.

(h) Cooperative organization security interest. A cooperative organization security interest becomes perfected when the cooperative interest first comes into existence and remains perfected so long as the cooperative interest exists.

Section 9-309. Security Interest Perfected upon Attachment.

The following security interests are perfected when they attach:

(1) a purchase-money security interest in consumer goods, except as otherwise provided in Section 9-311(b) with respect to consumer goods that are subject to a statute or treaty described in Section 9-311(a);

(2) an assignment of accounts or payment intangibles which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles;

(3) a sale of a payment intangible;

(4) a sale of a promissory note;

(5) a security interest created by the assignment of a health-care-insurance receivable to the provider of the health-care goods or services;

(6) a security interest arising under Section 2-401, 2-505, 2-711(3), or 2-A-508(5), until the debtor obtains possession of the collateral;

(7) a security interest of a collecting bank arising under Section 4-210;

(8) a security interest of an issuer or nominated person arising under Section 5-118;

(9) a security interest arising in the delivery of a financial asset under Section 9-206(c);

(10) a security interest in investment property created by a broker or securities intermediary;

(11) a security interest in a commodity contract or a commodity account created by a commodity intermediary;

(12) an assignment for the benefit of all creditors of the transferor and subsequent transfers by the assignee thereunder;

(13) a security interest created by an assignment of a beneficial interest in a decedent's estate; and

(14) a sale by an individual of an account that is a right to payment of winnings in a lottery or other game of chance.

Section 9-310. When Filing Required to Perfect Security Interest or Agricultural Lien; Security Interests and Agricultural Liens to Which Filing Provisions Do Not Apply.

(a) General rule: perfection by filing. Except as otherwise provided in subsection (b) and Section 9-312(b), a financing statement must be filed to perfect all security interests and agricultural liens.

(b) Exceptions: filing not necessary. Except as provided in subsection (d), the filing of a financing statement is not necessary to perfect a security interest:

(1) that is perfected under Section 9-308(d), (e), (f), or (g);

(2) that is perfected under Section 9-309 when it attaches;

(3) in property subject to a statute, regulation, or treaty described in Section 9-311(a);

(4) in goods in possession of a bailee which is perfected under Section 9-312(d)(1) or (2);

(5) in certificated securities, documents, goods, or instruments which is perfected without filing, control, or possession under Section 9-312(e), (f), or (g);

(6) in collateral in the secured party's possession under Section 9-313;

(7) in a certificated security which is perfected by delivery of the security certificate to the secured party under Section 9-313;

(8) in deposit accounts, electronic chattel paper, electronic documents, investment property, or letter-of-credit rights which is perfected by control under Section 9-314;

(9) in proceeds which is perfected under Section 9-315;

(10) that is perfected under Section 9-316; or

(11) that is a cooperative organization security interest.

(c) Assignment of perfected security interest. If a secured party assigns a perfected security interest or agricultural lien, a filing under this article is not required to continue the perfected status of the security interest against creditors of and transferees from the original debtor.

(d) Special rule for cooperative interests. Except for a cooperative organization security interest, a security interest in a cooperative interest may be perfected only by filing a financing statement.

Section 9-311. Perfection of Security Interests in Property Subject to Certain Statutes, Regulations, and Treaties.

(a) Security interest subject to other law. Except as otherwise provided in subsection (d), the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to:

(1) a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt Section 9-310(a);

(2) a certificate-of-title statute of this state or regulations promulgated thereunder, to the extent such statute or regulations provide for a security interest to be indicated on the certificate as a condition or result of perfection; or

(3) a statute of another jurisdiction which provides for a security interest to be indicated on a certificate of title as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the property.

(b) Compliance with other law. Compliance with the requirements of a statute, regulation, or treaty described in subsection (a) for obtaining priority over the rights of a lien creditor is equivalent to the filing of a financing statement under this article. Except as otherwise provided in subsection (d) and Sections 9-313 and 9-316(d) and (e) for goods covered by a certificate of title, a security interest in property subject to a statute, regulation, or treaty described in subsection (a) may be perfected only by compliance with those requirements, and a security interest so perfected remains perfected notwithstanding a change in the use or transfer of possession of the collateral.

(c) Duration and renewal of perfection. Except as otherwise provided in subsection (d) and Section 9-316(d) and (e), duration and renewal of perfection of a security interest perfected by compliance with the requirements prescribed by a statute, regulation, or treaty described in subsection (a) are governed by the statute, regulation, or treaty. In other respects, the security interest is subject to this article.

(d) Inapplicability to certain inventory. During any period in which collateral subject to a statute specified in subsection (a)(2) is inventory held for sale or lease by a person or leased by that person as lessor and that person is in the business of selling goods of that kind, this section does not apply to a security interest in that collateral created by that person.

Section 9-312. Perfection of Security Interests in Chattel Paper, Deposit Accounts, Documents, Goods Covered by Documents, Instruments, Investment Property, Letter-of-credit Rights, and Money; Perfection by Permissive Filing; Temporary Perfection Without Filing or Transfer of Possession.

(a) Perfection by filing permitted. A security interest in chattel paper, negotiable documents, instruments, or investment property may be perfected by filing.

(b) Control or possession of certain collateral. Except as otherwise provided in Section 9-315(c) and (d) for proceeds:

(1) a security interest in a deposit account may be perfected only by control under Section 9-314;

(2) and except as otherwise provided in Section 9-308(d), a security interest in a letter-of-credit right may be perfected only by control under Section 9-314; and

(3) a security interest in money may be perfected only by the secured party's taking possession under Section 9-313.

(c) Goods covered by negotiable document. While goods are in the possession of a bailee that has issued a negotiable document covering the goods:

(1) a security interest in the goods may be perfected by perfecting a security interest in the document; and

(2) a security interest perfected in the document has priority over any security interest that becomes perfected in the goods by another method during that time.

(d) Goods covered by nonnegotiable document. While goods are in the possession of a bailee that has issued a non-negotiable document covering the goods, a security interest in the goods may be perfected by:

(1) issuance of a document in the name of the secured party;

(2) the bailee's receipt of notification of the secured party's interest; or

(3) filing as to the goods.

(e) Temporary perfection: new value. A security interest in certificated securities, negotiable documents, or instruments is perfected without filing or the taking of possession or control for a period of 20 days from the time it attaches to the extent that it arises for new value given under an authenticated security agreement.

(f) Temporary perfection: goods or documents made available to debtor. A perfected security interest in a negotiable document or goods in possession of a bailee, other than one that has issued a negotiable document for the goods, remains perfected for 20 days without filing if the secured party makes available to the debtor the goods or documents representing the goods for the purpose of:

(1) ultimate sale or exchange; or

(2) loading, unloading, storing, shipping, transshipping, manufacturing, processing, or otherwise dealing with them in a manner preliminary to their sale or exchange.

(g) Temporary perfection: delivery of security certificate or instrument to debtor. A perfected security interest in a certificated security or instrument remains perfected for 20 days without filing if the secured party delivers the security certificate or instrument to the debtor for the purpose of:

(1) ultimate sale or exchange; or

(2) presentation, collection, enforcement, renewal, or registration of transfer.

(h) Expiration of temporary perfection. After the 20-day period specified in subsection (e), (f), or (g) expires, perfection depends upon compliance with this article.

(i) Cooperative interests. Subsections (a) through (h) do not apply to cooperative interests.

Section 9-313. When Possession by or Delivery to Secured Party Perfects Security Interest Without Filing.

(a) Perfection by possession or delivery. Except as otherwise provided in subsection (b), a secured party may perfect a security interest in tangible negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral. A secured party may perfect a security interest in certificated securities by taking delivery of the certificated securities under Section 8-301.

(b) Goods covered by certificate of title. With respect to goods covered by a certificate of title issued by this state, a secured party may perfect a security interest in the goods by taking possession of the goods only in the circumstances described in Section 9-316(d).

(c) Collateral in possession of person other than debtor. With respect to collateral other than certificated securities and goods covered by a document, a secured party takes possession of collateral in the possession of a person other than the debtor, the secured party, or a lessee of the collateral from the debtor in the ordinary course of the debtor's business, when:

(1) the person in possession authenticates a record acknowledging that it holds possession of the collateral for the secured party's benefit; or

(2) the person takes possession of the collateral after having authenticated a record acknowledging that it will hold possession of collateral for the secured party's benefit.

(d) Time of perfection by possession; continuation of perfection. If perfection of a security interest depends upon possession of the collateral by a secured party, perfection occurs no earlier than the time the secured party takes possession and continues only while the secured party retains possession.

(e) Time of perfection by delivery; continuation of perfection. A security interest in a certificated security in registered form is perfected by delivery when delivery of the certificated security occurs under Section 8-301 and remains perfected by delivery until the debtor obtains possession of the security certificate.

(f) Acknowledgment not required. A person in possession of collateral is not required to acknowledge that it holds possession for a secured party's benefit.

(g) Effectiveness of acknowledgment; no duties or confirmation. If a person acknowledges that it holds possession for the secured party's benefit:

(1) the acknowledgment is effective under subsection (c) or Section 8-301(a), even if the acknowledgment violates the rights of a debtor; and

(2) unless the person otherwise agrees or law other than this article otherwise provides, the person does not owe any duty to the secured party and is not required to confirm the acknowledgment to another person.

(h) Secured party's delivery to person other than debtor. A secured party having possession of collateral does not relinquish possession by delivering the collateral to a person other than the debtor or a lessee of the collateral from the debtor in the ordinary course of the debtor's business if the person was instructed before the delivery or is instructed contemporaneously with the delivery:

(1) to hold possession of the collateral for the secured party's benefit; or

(2) to redeliver the collateral to the secured party.

(i) Effect of delivery under subsection (h); no duties or confirmation. A secured party does not relinquish possession, even if a delivery under subsection (h) violates the rights of a debtor. A person to which collateral is delivered under subsection (h) does not owe any duty to the secured party and is not required to confirm the delivery to another person unless the person otherwise agrees or law other than this article otherwise provides.

(j) Cooperative interests. Subsections (a) through (i) do not apply to cooperative interests.

Section 9-314. Perfection by Control.

(a) Perfection by control. A security interest in investment property, deposit accounts, letter-of-credit rights, electronic chattel paper, or electronic documents may be perfected by control of the collateral under Section 7-106, 9-104, 9-105, 9-106, or 9-107.

(b) Specified collateral: time of perfection by control; continuation of perfection. A security interest in deposit accounts, electronic chattel paper, letter-of-credit rights, or electronic documents is perfected by control under Section 7-106, 9-104, 9-105, or 9—107 when the secured party obtains control and remains perfected by control only while the secured party retains control.

(c) Investment property: time of perfection by control; continuation of perfection. A security interest in investment property is perfected by control under Section 9-106 from the time the secured party obtains control and remains perfected by control until:

(1) the secured party does not have control; and

(2) one of the following occurs:

(A) if the collateral is a certificated security, the debtor has or acquires possession of the security certificate;

(B) if the collateral is an uncertificated security, the issuer has registered or registers the debtor as the registered owner; or

(C) if the collateral is a security entitlement, the debtor is or becomes the entitlement holder.

(d) Cooperative interests. Subsections (a) through (c) do not apply to cooperative interests

Section 9-315. Secured Party's Rights on Disposition of Collateral and in Proceeds.

(a) Disposition of collateral: continuation of security interest or agricultural lien; proceeds. Except as otherwise provided in this article and in Section 2-403(2):

(1) a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien; and

(2) a security interest attaches to any identifiable proceeds of collateral.

(b) When commingled proceeds identifiable. Proceeds that are commingled with other property are identifiable proceeds:

(1) if the proceeds are goods, to the extent provided by Section 9-336; and

(2) if the proceeds are not goods, to the extent that the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved.

(c) Perfection of security interest in proceeds. A security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected.

(d) Continuation of perfection. A perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless:

(1) the following conditions are satisfied:

(A) a filed financing statement covers the original collateral;

(B) the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed; and

(C) the proceeds are not acquired with cash proceeds;

(2) the proceeds are identifiable cash proceeds; or

(3) the security interest in the proceeds is perfected other than under subsection (c) when the security interest attaches to the proceeds or within 20 days thereafter.

(e) When perfected security interest in proceeds becomes unperfected. If a filed financing statement covers the original collateral, a security interest in proceeds which remains perfected under subsection (d)(1) becomes unperfected at the later of:

(1) when the effectiveness of the filed financing statement lapses under Section 9-515 or is terminated under Section 9-513; or

(2) the 21st day after the security interest attaches to the proceeds.

Section 9-316. Effect of Change in Governing Law.

(a) General rule: effect on perfection of change in governing law. A security interest perfected pursuant to the law of the jurisdiction designated in Section 9-301(a) or 9-305(c) remains perfected until the earliest of:

(1) the time perfection would have ceased under the law of that jurisdiction;

(2) the expiration of four months after a change of the debtor's location to another jurisdiction; or

(3) the expiration of one year after a transfer of collateral to a person that thereby becomes a debtor and is located in another jurisdiction.

(b) Security interest perfected or unperfected under law of new jurisdiction. If a security interest described in subsection (a) becomes perfected under the law of the other jurisdiction before the earliest time or event described in that subsection, it remains perfected thereafter. If the security interest does not become perfected under the law of the other jurisdiction before the earliest time or event, it becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.

(c) Possessory security interest in collateral moved to new jurisdiction. A possessory security interest in collateral, other than goods covered by a certificate of title and as-extracted collateral consisting of goods, remains continuously perfected if:

(1) the collateral is located in one jurisdiction and subject to a security interest perfected under the law of that jurisdiction;

(2) thereafter the collateral is brought into another jurisdiction; and

(3) upon entry into the other jurisdiction, the security interest is perfected under the law of the other jurisdiction.

(d) Goods covered by certificate of title from this state. Except as otherwise provided in subsection (e), a security interest in goods covered by a certificate of title which is perfected by any method under the law of another jurisdiction when the goods become covered by a certificate of title from this state remains perfected until the security interest would have become unperfected under the law of the other jurisdiction had the goods not become so covered.

(e) When subsection (d) security interest becomes unperfected against purchasers. A security interest described in subsection (d) becomes unperfected as against a purchaser of the goods for value and is deemed never to have been perfected as against a purchaser of the goods for value if the applicable requirements for perfection under Section 9-311(b) or 9-313 are not satisfied before the earlier of:

(1) the time the security interest would have become unperfected under the law of the other jurisdiction had the goods not become covered by a certificate of title from this state; or

(2) the expiration of four months after the goods had become so covered.

(f) Change in jurisdiction of bank, issuer, nominated person, securities intermediary, or commodity intermediary. A security interest in deposit accounts, letter-of-credit rights, or investment property which is perfected under the law of the bank's jurisdiction, the issuer's jurisdiction, a nominated person's jurisdiction, the securities intermediary's jurisdiction, or the commodity intermediary's jurisdiction, as applicable, remains perfected until the earlier of:

(1) the time the security interest would have become unperfected under the law of that jurisdiction; or

(2) the expiration of four months after a change of the applicable jurisdiction to another jurisdiction.

(g) Subsection (f) security interest perfected or unperfected under law of new jurisdiction. If a security interest described in subsection (f) becomes perfected under the law of the other jurisdiction before the earlier of the time or the end of the period described in that subsection, it remains perfected thereafter. If the security interest does not become perfected under the law of the other jurisdiction before the earlier of that time or the end of that period, it becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.

(h) Effect on filed financing statement of change in governing law. The following rules apply to collateral to which a security interest attaches within four months after the debtor changes its location to another jurisdiction:

(1) A financing statement filed before the change pursuant to the law of the jurisdiction designated in Section 9-301(a) or 9-305(c) is effective to perfect a security interest in the collateral if the financing statement would have been effective to perfect a security interest in the collateral had the debtor not changed its location.

(2) If a security interest perfected by a financing statement that is effective under paragraph (1) becomes perfected under the law of the other jurisdiction before the earlier of the time the financing statement would have become ineffective under the law of the jurisdiction designated in Section 9-301(a) or 9-305(c) or the expiration of the four-month period, it remains perfected thereafter. If the security interest does not become perfected under the law of the other jurisdiction before the earlier time or event, it becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.

(i) Effect of change in governing law on financing statement filed against original debtor. If a financing statement naming an original debtor is filed pursuant to the law of the jurisdiction designated in Section 9-301(a) or 9-305(c) and the new debtor is located in another jurisdiction, the following rules apply:

(1) The financing statement is effective to perfect a security interest in collateral in which the new debtor has or acquires rights before or within four months after the new debtor becomes bound under Section 9-203(d), if the financing statement would have been effective to perfect a security interest in the collateral had the collateral been acquired by the original debtor.

(2) A security interest that is perfected by the financing statement and which becomes perfected under the law of the other jurisdiction before the earlier of the expiration of the four month period or the time the financing statement would have become ineffective under the law of the jurisdiction designated in Section 9-301(a) or 9-305(c) remains perfected thereafter. A security interest that is perfected by the financing statement but which does not become perfected under the law of the other jurisdiction before the earlier time or event becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.

SubPart 3- PRIORITY

Section 9-317. Interests That Take Priority over or Take Free of Security Interest or Agricultural Lien.

(a) Conflicting security interests and rights of lien creditors. A security interest or agricultural lien is subordinate to the rights of:

(1) a person entitled to priority under Section 9-322; and

(2) except as otherwise provided in subsection (e), a person that becomes a lien creditor before the earlier of the time:

(A) the security interest or agricultural lien is perfected; or

(B) one of the conditions specified in Section 9-203(b)(3) is met and a financing statement covering the collateral is filed.

(b) Buyers that receive delivery. Except as otherwise provided in subsection (e), a buyer, other than a secured party, of tangible chattel paper, tangible documents, goods, instruments, or a certificated security takes free of a security interest or agricultural lien if the buyer gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien and before it is perfected.

(c) Lessees that receive delivery. Except as otherwise provided in subsection (e), a lessee of goods takes free of a security interest or agricultural lien if the lessee gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien and before it is perfected.

(d) Licensees and buyers of certain collateral. A licensee of a general intangible or a buyer, other than a secured party, of accounts, electronic chattel paper, electronic documents, general intangibles, or investment property other than a certificated security takes free of a security interest if the licensee or buyer gives value without knowledge of the security interest and before it is perfected.

(e) Purchase-money security interest. Except as otherwise provided in Sections 9-320 and 9-321, if a person files a financing statement with respect to a purchase-money security interest before or within 20 days after the debtor receives delivery of the collateral, the security interest takes priority over the rights of a buyer, lessee, or lien creditor which arise between the time the security interest attaches and the time of filing. The preceding sentence does not apply to cooperative interests.

Section 9-318. No Interest Retained in Right to Payment That Is Sold; Rights and Title of Seller of Account or Chattel Paper with Respect to Creditors and Purchasers.

(a) Seller retains no interest. A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.

(b) Deemed rights of debtor if buyer's security interest unperfected. For purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is

unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold.

Section 9-319. Rights and Title of Consignee with Respect to Creditors and Purchasers.

(a) Consignee has consignor's rights. Except as otherwise provided in subsection (b), for purposes of determining the rights of creditors of, and purchasers for value of goods from, a consignee, while the goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to those the consignor had or had power to transfer.

(b) Applicability of other law. For purposes of determining the rights of a creditor of a consignee, law other than this article determines the rights and title of a consignee while goods are in the consignee's possession if, under this part, a perfected security interest held by the consignor would have priority over the rights of the creditor.

Section 9-320. Buyer of Goods.

(a) Buyer in ordinary course of business. Except as otherwise provided in subsection (e), a buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence.

(b) Buyer of consumer goods. Except as otherwise provided in subsection (e), a buyer of goods from a person who used or bought the goods for use primarily for personal, family, or household purposes takes free of a security interest, even if perfected, if the buyer buys:

(1) without knowledge of the security interest;

(2) for value;

(3) primarily for the buyer's personal, family, or household purposes; and

(4) before the filing of a financing statement covering the goods.

(c) Effectiveness of filing for subsection (b). To the extent that it affects the priority of a security interest over a buyer of goods under subsection (b), the period of effectiveness of a filing made in the jurisdiction in which the seller is located is governed by Section 9-316(a) and (b).

(d) Buyer in ordinary course of business at wellhead or minehead. A buyer in ordinary course of business buying oil, gas, or other minerals at the wellhead or minehead or after extraction takes free of an interest arising out of an encumbrance.

(e) Possessory security interest not affected. Subsections (a) and (b) do not affect a security interest in goods in the possession of the secured party under Section 9-313.

Section 9-321. Licensee of General Intangible and Lessee of Goods in Ordinary Course of Business.

(a) "Licensee in ordinary course of business." In this section, "licensee in ordinary course of business" means a person that becomes a licensee of a general intangible in good faith, without knowledge that the license violates the rights of another person in the general intangible, and in the ordinary course from a person in the business of licensing general intangibles of that kind. A person becomes a licensee in the ordinary course if the license to the person comports with the usual or customary practices in the kind of business in which the licensor is engaged or with the licensor's own usual or customary practices.

(b) Rights of licensee in ordinary course of business. A licensee in ordinary course of business takes its rights under a nonexclusive license free of a security interest in the general intangible created by the licensor, even if the security interest is perfected and the licensee knows of its existence.

(c) Rights of lessee in ordinary course of business. A lessee in ordinary course of business takes its leasehold interest free of a security interest in the goods created by the lessor, even if the security interest is perfected and the lessee knows of its existence.

Section 9-322. Priorities among Conflicting Security Interests in and Agricultural Liens on Same Collateral.

(a) General priority rules. Except as otherwise provided in this section, priority among conflicting security interests and agricultural liens in the same collateral is determined according to the following rules:

(1) Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection.

(2) A perfected security interest or agricultural lien has priority over a conflicting unperfected security interest or agricultural lien.

(3) The first security interest or agricultural lien to attach or become effective has priority if conflicting security interests and agricultural liens are unperfected.

(b) Time of perfection: proceeds and supporting obligations. For the purposes of subsection (a)(1):

(1) the time of filing or perfection as to a security interest in collateral is also the time of filing or perfection as to a security interest in proceeds; and

(2) the time of filing or perfection as to a security interest in collateral supported by a supporting obligation is also the time of filing or perfection as to a security interest in the supporting obligation.

(c) Special priority rules: proceeds and supporting obligations. Except as otherwise provided in subsection (f), a security interest in collateral which qualifies for priority over a conflicting security interest under Section 9-327, 9-328, 9-329, 9-330, or 9-331 also has priority over a conflicting security interest in:

(1) any supporting obligation for the collateral; and

(2) proceeds of the collateral if:

(A) the security interest in proceeds is perfected;

(B) the proceeds are cash proceeds or of the same type as the collateral; and

(C) in the case of proceeds that are proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral.

(d) First-to-file priority rule for certain collateral. Subject to subsection (e) and except as otherwise provided in subsection (f), if a security interest in chattel paper, deposit accounts, negotiable documents, instruments, investment property, or letter-of-credit rights is perfected by a method other than filing, conflicting perfected security interests in proceeds of the collateral rank according to priority in time of filing.

(e) Applicability of subsection (d). Subsection (d) applies only if the proceeds of the collateral are not cash proceeds, chattel paper, negotiable documents, instruments, investment property, or letter-of-credit rights.

(f) Limitations on subsections (a) through (e). Subsections (a) through (e) are subject to:

(1) subsection (g) and the other provisions of this part;

(2) Section 4-210 with respect to a security interest of a collecting bank;

(3) Section 5-118 with respect to a security interest of an issuer or nominated person; and

(4) Section 9-110 with respect to a security interest arising under Article 2 or 2-A.

(g) Priority under agricultural lien statute. A perfected agricultural lien on collateral has priority over a conflicting security interest in or agricultural lien on the same collateral if the statute creating the agricultural lien so provides.

(h) Special priority rules: cooperative interests.

(1) With respect to all amounts secured, a cooperative organization security interest has priority over all other security interests in a cooperative interest.

(2) As to security interests in cooperative interests other than cooperative organization security interests, Section 9-323(h) provides special rules for future advances.

Section 9-323. Future Advances.

(a) When priority based on time of advance. Except as otherwise provided in subsection (c), for purposes of determining the priority of a perfected security interest under Section 9-322(a)(1), perfection of the security interest dates from the time an advance is made to the extent that the security interest secures an advance that:

(1) is made while the security interest is perfected only:

(A) under Section 9-309 when it attaches; or

(B) temporarily under Section 9-312(e), (f), or (g); and

(2) is not made pursuant to a commitment entered into before or while the security interest is perfected by a method other than under Section 9-309 or 9-312(e), (f), or (g).

(b) Lien creditor. Except as otherwise provided in subsections (c) and (h), a security interest is subordinate to the rights of a person that becomes a lien creditor to the extent that the security interest secures an advance made more than 45 days after the person becomes a lien creditor unless the advance is made:

(1) without knowledge of the lien; or

(2) pursuant to a commitment entered into without knowledge of the lien.

(c) Buyer of receivables. Subsections (a) and (b) do not apply to a security interest held by a secured party that is a buyer of accounts, chattel paper, payment intangibles, or promissory notes or a consignor.

(d) Buyer of goods. Except as otherwise provided in subsection (e), a buyer of goods other than a buyer in ordinary course of business takes free of a security interest to the extent that it secures advances made after the earlier of:

(1) the time the secured party acquires knowledge of the buyer's purchase; or

(2) 45 days after the purchase.

(e) Advances made pursuant to commitment: priority of buyer of goods. Subsection (d) does not apply if the advance is made pursuant to a commitment entered into without knowledge of the buyer's purchase and before the expiration of the 45 day period.

(f) Lessee of goods. Except as otherwise provided in subsection (g), a lessee of goods, other than a lessee in ordinary course of business, takes the leasehold interest free of a security interest to the extent that it secures advances made after the earlier of:

(1) the time the secured party acquires knowledge of the lease; or

(2) 45 days after the lease contract becomes enforceable.

(g) Advances made pursuant to commitment: priority of lessee of goods. Subsection (f) does not apply if the advance is made pursuant to a commitment entered into without knowledge of the lease and before the expiration of the 45 day period. (h) Priority with respect to cooperative interests. The following rules apply for purposes of determining under Section 9-322(a)(1) the priority of a perfected security interest in a cooperative interest:

(1) Perfection of the security interest with respect to a future advance dates from the time of the filing under Section 9-310(d) if all of the following are true:

(A) The security agreement states the maximum amount to be advanced pursuant to commitment;

(B) The future advance is made pursuant to that commitment;

(C) The future advance plus the outstanding sum of any prior advances is not more than the stated maximum amount; and

(D) The filed financing statement includes a cooperative addendum disclosing that the security agreement contains a commitment to make future advances.

(2) Except as provided in paragraph (1), perfection of the security interest with respect to a future advance dates from the time the advance is made.

(3) For purposes of paragraph (1), no amendment of a security agreement shall adversely affect the priority of any other security interest in the same cooperative interest that was perfected prior to the amendment.

(4) This subsection applies only to advances made subsequent to an initial advance.

Section 9-324. Priority of Purchase-money Security Interests.

(a) General rule: purchase-money priority. Except as otherwise provided in subsection (g), a perfected purchase-money security interest in goods other than inventory or livestock has priority over a conflicting security interest in the same goods, and, except as otherwise provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20 days thereafter.

(b) Inventory purchase-money priority. Subject to subsection (c) and except as otherwise provided in subsection (g), a perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory, has priority over a conflicting security interest in chattel paper or an instrument constituting proceeds of the inventory and in proceeds of the chattel paper, if so provided in Section 9-330, and, except as otherwise provided in Section 9-327, also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:

(1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;

(2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;

(3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

(4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

(c) Holders of conflicting inventory security interests to be notified. Subsections (b)(2) through (4) apply only if the holder of the conflicting security interest had filed a financing statement covering the same types of inventory:

(1) if the purchase-money security interest is perfected by filing, before the date of the filing; or

(2) if the purchase-money security interest is temporarily perfected without filing or possession under Section 9-312(f), before the beginning of the 20-day period thereunder.

(d) Livestock purchase-money priority. Subject to subsection (e) and except as otherwise provided in subsection (g), a perfected purchase-money security interest in livestock that are

farm products has priority over a conflicting security interest in the same livestock, and, except as otherwise provided in Section 9-327, a perfected security interest in their identifiable proceeds and identifiable products in their unmanufactured states also has priority, if:

(1) the purchase-money security interest is perfected when the debtor receives possession of the livestock;

(2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;

(3) the holder of the conflicting security interest receives the notification within six months before the debtor receives possession of the livestock; and

(4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in livestock of the debtor and describes the livestock.

(e) Holders of conflicting livestock security interests to be notified. Subsections (d)(2) through (4) apply only if the holder of the conflicting security interest had filed a financing statement covering the same types of livestock:

(1) if the purchase-money security interest is perfected by filing, before the date of the filing; or

(2) if the purchase-money security interest is temporarily perfected without filing or possession under Section 9-312(f), before the beginning of the 20-day period thereunder.

(f) Software purchase-money priority. Except as otherwise provided in subsection (g), a perfected purchase-money security interest in software has priority over a conflicting security interest in the same collateral, and, except as otherwise provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, to the extent that the purchase-money security interest in the goods in which the software was acquired for use has priority in the goods and proceeds of the goods under this section.

(g) Conflicting purchase-money security interests. If more than one security interest qualifies for priority in the same collateral under subsection (a), (b), (d), or (f):

(1) a security interest securing an obligation incurred as all or part of the price of the collateral has priority over a security interest securing an obligation incurred for value given to enable the debtor to acquire rights in or the use of collateral; and

(2) in all other cases, Section 9-322(a) applies to the qualifying security interests.

Section 9-325. Priority of Security Interests in Transferred Collateral.

(a) Subordination of security interest in transferred collateral. Except as otherwise provided in subsection (b), a security interest created by a debtor is subordinate to a security interest in the same collateral created by another person if:

(1) the debtor acquired the collateral subject to the security interest created by the other person;

(2) the security interest created by the other person was perfected when the debtor acquired the collateral; and

(3) there is no period thereafter when the security interest is unperfected.

(b) Limitation of subsection (a) subordination. Subsection (a) subordinates a security interest only if the security interest:

(1) otherwise would have priority solely under Section 9-322(a) or 9-324; or

(2) arose solely under Section 2-711(3) or 2-A-508(5).

Section 9-326. Priority of Security Interests Created by New Debtor.

(a) Subordination of security interest created by new debtor. Subject to subsection (b), a security interest that is created by a new debtor in collateral in which the new debtor has or acquires rights and is perfected solely by a filed financing statement that would be ineffective to perfect the security interest but for the application of Section 9-316(i)(1) or 9-508 is subordinate to a security interest in the same collateral which is perfected other than by such a filed financing statement.

(b) Priority under other provisions; multiple original debtors. The other provisions of this part determine the priority among conflicting security interests in the same collateral perfected by filed financing statements described in subsection (a). However, if the security agreements to which a new debtor became bound as debtor were not entered into by the same original debtor, the conflicting security interests rank according to priority in time of the new debtor's having become bound.

Section 9-327. Priority of Security Interests in Deposit Account.

The following rules govern priority among conflicting security interests in the same deposit account:

(a) A security interest held by a secured party having control of the deposit account under Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control.

(b) Except as otherwise provided in subsections (c) and (d), security interests perfected by control under Section 9-314 rank according to priority in time of obtaining control.

(c) Except as otherwise provided in subsection (d), a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party.

(d) A security interest perfected by control under Section 9-104(a)(3) has priority over a security interest held by the bank with which the deposit account is maintained.

Section 9-328. Priority of Security Interests in Investment Property.

The following rules govern priority among conflicting security interests in the same investment property:

(a) A security interest held by a secured party having control of investment property under Section 9-106 has priority over a security interest held by a secured party that does not have control of the investment property.

(b) Except as otherwise provided in paragraphs (c) and (d), conflicting security interests held by secured parties each of which has control under Section 9-106 rank according to priority in time of:

(1) if the collateral is a security, obtaining control;

(2) if the collateral is a security entitlement carried in a securities account and:

(A) if the secured party obtained control under Section 8-106 (d) (1), the secured party's becoming the person for which the securities account is maintained;

(B) if the secured party obtained control under Section 8-106 (d) (2), the securities intermediary's agreement to comply with the secured party's entitlement orders with respect to security entitlements carried or to be carried in the securities account; or

(C) if the secured party obtained control through another person under Section 8-106 (d) (3), the time on which priority would be based under this paragraph if the other person were the secured party; or

(3) if the collateral is a commodity contract carried with a commodity intermediary, the satisfaction of the requirement for control specified in Section 9-106 (b) (2) with respect to commodity contracts carried or to be carried with the commodity intermediary.

(c) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.

(d) A security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by another secured party.

(e) A security interest in a certificated security in registered form which is perfected by taking delivery under Section 9-313 (a) and not by control under Section 9-314 has priority over a conflicting security interest perfected by a method other than control.

(f) Conflicting security interests created by a broker, securities intermediary, or commodity intermediary which are perfected without control under Section 9-106 rank equally.

(g) In all other cases, priority among conflicting security interests in investment property is governed by Sections 9-322 and 9-323.

(h) Subsections (a) through (g) do not apply to cooperative interests.

Section 9-329. Priority of Security Interests in Letter-of-credit Right.

The following rules govern priority among conflicting security interests in the same letter-of-credit right:

(a) A security interest held by a secured party having control of the letter-of-credit right under Section 9-107 has priority to the extent of its control over a conflicting security interest held by a secured party that does not have control.

(b) Security interests perfected by control under Section 9-314 rank according to priority in time of obtaining control.

Section 9-330. Priority of Purchaser of Chattel Paper or Instrument.

(a) Purchaser's priority: security interest claimed merely as proceeds. A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if:

(1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105; and

(2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.

(b) Purchaser's priority: other security interests. A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed other than merely as proceeds of inventory subject to a security interest if the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105 in good faith, in the ordinary course of the purchaser's business, and without knowledge that the purchase violates the rights of the secured party.

(c) Chattel paper purchaser's priority in proceeds. Except as otherwise provided in Section 9-327, a purchaser having priority in chattel paper under subsection (a) or (b) also has priority in proceeds of the chattel paper to the extent that:

(1) Section 9-322 provides for priority in the proceeds; or

(2) the proceeds consist of the specific goods covered by the chattel paper or cash proceeds of the specific goods, even if the purchaser's security interest in the proceeds is unperfected.

(d) Instrument purchaser's priority. Except as otherwise provided in Section 9-331(a), a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party.

(e) Holder of purchase-money security interest gives new value. For purposes of subsections (a) and (b), the holder of a purchase-money security interest in inventory gives new value for chattel paper constituting proceeds of the inventory.

(f) Indication of assignment gives knowledge. For purposes of subsections (b) and (d), if chattel paper or an instrument indicates that it has been assigned to an identified secured party other than the purchaser, a purchaser of the chattel paper or instrument has knowledge that the purchase violates the rights of the secured party.

Section 9-331. Priority of Rights of Purchasers of Instruments, Documents, and Securities under Other Articles; Priority of Interests in Financial Assets and Security Entitlements under Article 8.

(a) Rights under Articles 3, 7, and 8 not limited. This article does not limit the rights of a holder in due course of a negotiable instrument, a holder to which a negotiable document of title has been duly negotiated, or a protected purchaser of a security. These holders or purchasers take priority over an earlier security interest, even if perfected, to the extent provided in Articles 3, 7, and 8.

(b) Protection under Article 8. This article does not limit the rights of or impose liability on a person to the extent that the person is protected against the assertion of a claim under Article 8.

(c) Filing not notice. Filing under this article does not constitute notice of a claim or defense to the holders, or purchasers, or persons described in subsections (a) and (b).

(d) Section not applicable to cooperative interests. Subsections (a), (b), and (c) do not apply to cooperative interests.

Section 9-332. Transfer of Money; Transfer of Funds from Deposit Account.

(a) Transferee of money. A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party.

(b) Transferee of funds from deposit account. A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.

Section 9-333. Priority of Certain Liens Arising by Operation of Law.

(a) "Possessory lien." In this section, "possessory lien" means an interest, other than a security interest or an agricultural lien:

(1) which secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person's business;

(2) which is created by statute or rule of law in favor of the person; and

(3) whose effectiveness depends on the person's possession of the goods.

(b) Priority of possessory lien. A possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise.

Section 9-334. Priority of Security Interests in Fixtures and Crops.

(a) Security interest in fixtures under this article. A security interest under this article may be created in goods that are fixtures or may continue in goods that become fixtures. A security interest does not exist under this article in ordinary building materials incorporated into an improvement on land.

(b) Security interest in fixtures under real property law. This article does not prevent creation of an encumbrance upon fixtures under real property law.

(c) General rule: subordination of security interest in fixtures. In cases not governed by subsections (d) through (h), a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the related real property other than the debtor.

(d) Fixtures purchase-money priority. Except as otherwise provided in subsection (h), a perfected security interest in fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if the debtor has an interest of record in or is in possession of the real property and:

(1) the security interest is a purchase-money security interest;

(2) the interest of the encumbrancer or owner arises before the goods become fixtures; and

(3) the security interest is perfected by a fixture filing before the goods become fixtures or within 20 days thereafter.

(e) Priority of security interest in fixtures over interests in real property. A perfected security interest in fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if:

(1) the debtor has an interest of record in the real property or is in possession of the real property and the security interest:

(A) is perfected by a fixture filing before the interest of the encumbrancer or owner is of record; and

(B) has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner;

(2) before the goods become fixtures, the security interest is perfected by any method permitted by this article and the fixtures are readily removable:

(A) factory or office machines;

(B) equipment that is not primarily used or leased for use in the operation of the real property; or

(C) replacements of domestic appliances that are consumer goods;

(3) the conflicting interest is a lien on the real property obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this article; or

(4) the security interest is:

(A) created in a manufactured home in a manufactured-home transaction; and

(B) perfected pursuant to a statute described in Section 9-311(a)(2).

(f) Priority based on consent, disclaimer, or right to remove. A security interest in fixtures, whether or not perfected, has priority over a conflicting interest of an encumbrancer or owner of the real property if:

(1) the encumbrancer or owner has, in an authenticated record, consented to the security interest or disclaimed an interest in the goods as fixtures; or

(2) the debtor has a right to remove the goods as against the encumbrancer or owner.

(g) Continuation of paragraph (f)(2) priority. The priority of the security interest under paragraph (f)(2) continues for a reasonable time if the debtor's right to remove the goods as against the encumbrancer or owner terminates.

(h) Priority of construction mortgage. A mortgage is a construction mortgage to the extent that it secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land, if a recorded record of the mortgage so indicates. Except as otherwise provided in subsections (e) and (f), a security interest in fixtures is subordinate to a construction mortgage if a record of the mortgage is recorded before the goods become fixtures and the goods become fixtures before the completion of the construction. A mortgage has this priority to the same extent as a construction mortgage to the extent that it is given to refinance a construction mortgage.

(i) Priority of security interest in crops. A perfected security interest in crops growing on real property has priority over a conflicting interest of an encumbrancer or owner of the real property if the debtor has an interest of record in or is in possession of the real property.

(j) Subsection (i) prevails. Subsection (i) prevails over any inconsistent provisions with this article or any other chapter of law.

Section 9-335. Accessions.

(a) Creation of security interest in accession. A security interest may be created in an accession and continues in collateral that becomes an accession.

(b) Perfection of security interest. If a security interest is perfected when the collateral becomes an accession, the security interest remains perfected in the collateral.

(c) Priority of security interest. Except as otherwise provided in subsection (d), the other provisions of this part determine the priority of a security interest in an accession.

(d) Compliance with certificate-of-title statute. A security interest in an accession is subordinate to a security interest in the whole which is perfected by compliance with the requirements of a certificate-of-title statute under Section 9-311 (b).

(e) Removal of accession after default. After default, subject to Part 6, a secured party may remove an accession from other goods if the security interest in the accession has priority over the claims of every person having an interest in the whole.

(f) Reimbursement following removal. A secured party that removes an accession from other goods under subsection (e) shall promptly reimburse any holder of a security interest or other lien on, or owner of, the whole or of the other goods, other than the debtor, for the cost of repair of any physical injury to the whole or the other goods. The secured party need not reimburse the holder or owner for any diminution in value of the whole or the other goods caused by the absence of the accession removed or by any necessity for replacing it. A person entitled to reimbursement may refuse permission to remove until the secured party gives adequate assurance for the performance of the obligation to reimburse.

Section 9-336. Commingled Goods.

(a) "Commingled goods." In this section, "commingled goods" means goods that are physically united with other goods in such a manner that their identity is lost in a product or mass.

(b) No security interest in commingled goods as such. A security interest does not exist in commingled goods as such. However, a security interest may attach to a product or mass that results when goods become commingled goods.

(c) Attachment of security interest to product or mass. If collateral becomes commingled goods, a security interest attaches to the product or mass.

(d) Perfection of security interest. If a security interest in collateral is perfected before the collateral becomes commingled goods, the security interest that attaches to the product or mass under subsection (c) is perfected.

(e) Priority of security interest Except as otherwise provided in subsection (f), the other provisions of this part determine the priority of a security interest that attaches to the product or mass under subsection (c).

(f) Conflicting security interests in product or mass If more than one security interest attaches to the product or mass under subsection (c), the following rules determine priority:

(1) A security interest that is perfected under subsection (d) has priority over a security interest that is unperfected at the time the collateral becomes commingled goods.

(2) If more than one security interest is perfected under subsection (d), the security interests rank equally in proportion to the value of the collateral at the time it became commingled goods.

Section 9-337. Priority of Security Interests in Goods Covered by Certificate of Title.

If, while a security interest in goods is perfected by any method under the law of another jurisdiction, this state issues a certificate of title that does not show that the goods are subject to the security interest or contain a statement that they may be subject to security interests not shown on the certificate:

(a) a buyer of the goods, other than a person in the business of selling goods of that kind, takes free of the security interest if the buyer gives value and receives delivery of the goods after issuance of the certificate and without knowledge of the security interest; and

(b) the security interest is subordinate to a conflicting security interest in the goods that attaches, and is perfected under Section 9-311 (b), after issuance of the certificate and without the conflicting secured party's knowledge of the security interest.

Section 9-338. Priority of Security Interest or Agricultural Lien Perfected by Filed Financing Statement Providing Certain Incorrect Information.

If a security interest or agricultural lien is perfected by a filed financing statement providing information described in Section 9-516(b)(5) which is incorrect at the time the financing statement is filed:

(1) the security interest or agricultural lien is subordinate to a conflicting perfected security interest in the collateral to the extent that the holder of the conflicting security interest gives value in reasonable reliance upon the incorrect information; and

(2) a purchaser, other than a secured party, of the collateral takes free of the security interest or agricultural lien to the extent that, in reasonable reliance upon the incorrect information, the purchaser gives value and, in the case of tangible chattel paper, tangible documents, goods, instruments, or a security certificate, receives delivery of the collateral.

Section 9-339. Priority Subject to Subordination.

This article does not preclude subordination by agreement by a person entitled to priority.

SubPart 4- RIGHTS OF BANK

Section 9-340. Effectiveness of Right of Recoupment or Set-off Against Deposit Account.

(a) Exercise of recoupment or set-off. Except as otherwise provided in subsection (c), a bank with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account.

(b) Recoupment or set-off not affected by security interest. Except as otherwise provided in subsection (c), the application of this article to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party.

(c) When set-off ineffective. The exercise by a bank of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control under Section 9-104(a)(3), if the set-off is based on a claim against the debtor.

Section 9-341. Bank's Rights and Duties with Respect to Deposit Account.

Except as otherwise provided in Section 9-340 (c), and unless the bank otherwise agrees in an authenticated record, a bank's rights and duties with respect to a deposit account maintained with the bank are not terminated, suspended, or modified by:

(a) the creation, attachment, or perfection of a security interest in the deposit account;

(b) the bank's knowledge of the security interest; or

(c) the bank's receipt of instructions from the secured party.

Section 9-342. Bank's Right to Refuse to Enter into or Disclose Existence of Control Agreement.

This article does not require a bank to enter into an agreement of the kind described in Section 9-104(a)(2), even if its customer so requests or directs. A bank that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

Part 4 - RIGHTS OF THIRD PARTIES

Section 9-401. Alienability of Debtor's Rights.

(a) Other law governs alienability; exceptions. Except as otherwise provided in subsection (b) and Sections 9-406, 9-407, 9-408, and 9-409, whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than this article.

(b) Agreement does not prevent transfer. An agreement between the debtor and secured party which prohibits a transfer of the debtor's rights in collateral or makes the transfer a default does not prevent the transfer from taking effect.

Section 9-402. Secured Party Not Obligated on Contract of Debtor or in Tort.

The existence of a security interest, agricultural lien, or authority given to a debtor to dispose of or use collateral, without more, does not subject a secured party to liability in contract or tort for the debtor's acts or omissions.

Section 9-403. Agreement Not to Assert Defenses Against Assignee.

(a) "Value." In this section, "value" has the meaning provided in Section 3-303. In this section the meaning of "obligor" is not limited to the meaning given it in Section 9-102(a)(59). In this section the term "person entitled to enforce the instrument" means (i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Article 3 of this chapter. A person may be a person entitled to enforce

the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

(b) Agreement not to assert claim or defense. Except as otherwise provided in this section, an agreement between an account debtor and an assignor not to assert against an assignee any claim or defense that the account debtor may have against the assignor is enforceable by an assignee that takes an assignment:

(1) for value;

(2) in good faith;

(3) without notice of a claim of a property or possessory right to the property assigned; and

(4) without notice of:

(A) a defense of the obligor based on (i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in solving proceedings;

(B) a defense of the obligor stated anywhere in Article 3 of this chapter or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract; and

(C) a claim in recoupment of the obligor against the assignor if the claim arose from the transaction that gave rise to the assigned obligation, but the claim of the obligor may be asserted against an assignee only to reduce the amount owing on the assigned obligation at the time the action is brought.

(c) When subsection (b) not applicable. An assignee takes subject to the defenses listed in paragraph (b)(4)(A), but is not subject to defenses of the obligor stated in paragraph (b)(4)(B) or claims in recoupment stated in paragraph (b)(4)(C) against a person other than the enforcing assignee.

(d) Omission of required statement in consumer transaction. In a consumer transaction, if a record evidences the account debtor's obligation, law other than this article requires that the record include a statement to the effect that the rights of an assignee are subject to claims or defenses that the account debtor could assert against the original obligee, and the record does not include such a statement:

(1) the record has the same effect as if the record included such a statement; and

(2) the account debtor may assert against an assignee those claims and defenses that would have been available if the record included such a statement.

(e) Rule for individual under other law. This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

(f) Other law not displaced. Except as otherwise provided in subsection (d), this section does not displace law other than this article which gives effect to an agreement by an account debtor not to assert a claim or defense against an assignee.

Section 9-404. Rights Acquired by Assignee; Claims and Defenses Against Assignee.

(a) Assignee's rights subject to terms, claims, and defenses; exceptions. Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to:

(1) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and (2) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

(b) Account debtor's claim reduces amount owed to assignee. Subject to subsection (c) and except as otherwise provided in subsection (d), the claim of an account debtor against an assignor may be asserted against an assignee under subsection (a) only to reduce the amount the account debtor owes.

(c) Rule for individual under other law. This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

(d) Omission of required statement in consumer transaction. In a consumer transaction, if a record evidences the account debtor's obligation, law other than this article requires that the record include a statement to the effect that the account debtor's recovery against an assignee with respect to claims and defenses against the assignor may not exceed amounts paid by the account debtor under the record, and the record does not include such a statement, the extent to which a claim of an account debtor against the assignor may be asserted against an assignee is determined as if the record included such a statement. (e) Inapplicability to health-care-insurance receivable. This section does not apply to an assignment of a health-care-insurance receivable.

Section 9-405. Modification of Assigned Contract.

(a) Effect of modification on assignee. A modification of or substitution for an assigned contract is effective against an assignee if made in good faith. The assignee acquires corresponding rights under the modified or substituted contract. The assignment may provide that the modification or substitution is a breach of contract by the assignor. This subsection is subject to subsections (b) through (d).

(b) Applicability of subsection (a). Subsection (a) applies to the extent that:

(1) the right to payment or a part thereof under an assigned contract has not been fully earned by performance; or

(2) the right to payment or a part thereof has been fully earned by performance and the account debtor has not received notification of the assignment under Section 9-406(a).

(c) Rule for individual under other law. This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

(d) Inapplicability to health-care-insurance receivable. This section does not apply to an assignment of a health-care-insurance receivable.

Section 9-406. Discharge of Account Debtor; Notification of Assignment; Identification and Proof of Assignment; Restrictions on Assignment of Accounts, Chattel Paper, Payment Intangibles, and Promissory Notes Ineffective.

(a) Discharge of account debtor; effect of notification. Subject to subsections (b) through (h), an account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

(b) When notification ineffective. Subject to subsection (g), notification is ineffective under subsection (a):

(1) if it does not reasonably identify the rights assigned;

(2) to the extent that an agreement between an account debtor and a seller of a payment intangible limits the account debtor's duty to pay a person other than the seller and the limitation is effective under law other than this article; or

(3) at the option of an account debtor, if the notification notifies the account debtor to make less than the full amount of any installment or other periodic payment to the assignee, even if:

(A) only a portion of the account, chattel paper, or payment intangible has been assigned to that assignee; (B) a portion has been assigned to another assignee; or

(C) the account debtor knows that the assignment to that assignee is limited.

(c) Proof of assignment. Subject to subsection (g), if requested by the account debtor, an assignee shall seasonably furnish reasonable proof that the assignment has been made. Unless the assignee complies, the account debtor may discharge its obligation by paying the assignor, even if the account debtor has received a notification under subsection (a).

(d) Term restricting assignment generally ineffective. Except as otherwise provided in subsection (e) and Sections 2-A-303 and 9-407, and subject to subsection (g), a term in an agreement between an account debtor and an assignor or in a promissory note is ineffective to the extent that it:

(1) prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account, chattel paper, payment intangible, or promissory note; or

(2) provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the account, chattel paper, payment intangible, or promissory note.

(e) Inapplicability of subsection (d) to certain sales. Subsection (d) does not apply to the sale of a payment intangible or promissory note.

(f) Subsection (b)(3) not waivable. Subject to subsection (g), an account debtor may not waive or vary its option under subsection (b)(3).

(g) Rule for individual under other law. This section is subject to a rule of law, statute, rule or regulation other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.

(h) Inapplicability. This section does not apply to:

(1) an assignment of a health care insurance receivable to the extent such assignment conflicts with other law or the parties have otherwise agreed in writing that such receivable is non-assignable,

(2) a claim or right to receive compensation for injuries or sickness as described in 26 U.S.C. § 104(a)(1) and (2), as amended from time to time, or

(3) a claim or right to receive benefits under a special needs trust as described in 42 U.S.C. § 1396p (d)(4), as amended from time to time.

Section 9-407. Restrictions on Creation or Enforcement of Security Interest in Leasehold Interest or in Lessor's Residual Interest.

(a) Term restricting assignment generally ineffective. Except as otherwise provided in subsection (b), a term in a lease agreement is ineffective to the extent that it:

(1) prohibits, restricts, or requires the consent of a party to the lease to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, an interest of a party under the lease contract or in the lessor's residual interest in the goods; or

(2) provides that the assignment or transfer or the creation, attachment, perfection, or enforcement of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the lease.

(b) Effectiveness of certain terms. Except as otherwise provided in Section 2-A-303(7), a term described in subsection (a)(2) is effective to the extent that there is:

(1) a transfer by the lessee of the lessee's right of possession or use of the goods in violation of the term; or

(2) a delegation of a material performance of either party to the lease contract in violation of the term.

(c) Security interest not material impairment. The creation, attachment, perfection, or enforcement of a security interest in the lessor's interest under the lease contract or the lessor's residual interest in the goods is not a transfer that materially impairs the lessee's prospect of obtaining return performance or materially changes the duty of or materially increases the burden or risk imposed on the lessee within the purview of Section 2-A-303(4) unless, and then only to the extent that, enforcement actually results in a delegation of material performance of the lessor.

Section 9-408. Restrictions on Assignment of Promissory Notes, Health-care-insurance Receivables, and Certain General Intangibles Ineffective.

(a) Term restricting assignment generally ineffective. Except as otherwise provided in subsection (b), a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or a general intangible, including a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the person obligated on the promissory note or the account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the promissory note, health-care-insurance receivable, or general intangible, is ineffective to the extent that the term:

(1) would impair the creation, attachment, or perfection of a security interest; or

(2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

(b) Applicability of subsection (a) to sales of certain rights to payment. Subsection (a) applies to a security interest in a payment intangible or promissory note only if the security interest arises out of a sale of the payment intangible or promissory note.

(c) Limitation on ineffectiveness under subsection (a). To the extent that a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health-care-insurance receivable or general intangible would be effective under law other than this article but is ineffective under subsection (a), the creation, attachment, or perfection of a security interest in the promissory note, health-care-insurance receivable, or general intangible:

(1) is not enforceable against the person obligated on the promissory note or the account debtor;

(2) does not impose a duty or obligation on the person obligated on the promissory note or the account debtor;

(3) does not require the person obligated on the promissory note or the account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;

(4) does not entitle the secured party to use or assign the debtor's rights under the promissory note, health-care-insurance receivable, or general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the promissory note, health-care-insurance receivable, or general intangible;

(5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the promissory note or the account debtor; and

(6) does not entitle the secured party to enforce the security interest in the promissory note, health-care-insurance receivable, or general intangible.

(d) Inapplicability. This section does not apply to:

(1) a claim or right to receive compensation for injuries or sickness as described in 26 U.S.C. § 104(a)(1) and (2), as amended from time to time, or

(2) a claim or right to receive benefits under a special needs trust as described in 42 U.S.C. § 1396p (d)(4), as amended from time to time.

Section 9-409. Restrictions on Assignment of Letter-of-credit Rights Ineffective.

(a) Term or law restricting assignment generally ineffective. A term in a letter-of-credit or a rule of law, statute, regulation, custom, or practice applicable to the letter of credit which prohibits, restricts, or requires the consent of an applicant, issuer, or nominated person to a beneficiary's assignment of or creation of a security interest in a letter-of-credit right is ineffective to the extent that the term or rule of law, statute, regulation, custom, or practice:

(1) would impair the creation, attachment, or perfection of a security interest in the letter-of-credit right; or

(2) provides that the assignment or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the letter-of-credit right.

(b) Limitation on ineffectiveness under subsection (a). To the extent that a term in a letter-of-credit is ineffective under subsection (a) but would be effective under law other than this article or a custom or practice applicable to the letter-of-credit, to the transfer of a right to draw or otherwise demand performance under the letter-of-credit, or to the assignment of a right to proceeds of the letter-of-credit, the creation, attachment, or perfection of a security interest in the letter-of-credit right:

(1) is not enforceable against the applicant, issuer, nominated person, or transferee beneficiary;

(2) imposes no duties or obligations on the applicant, issuer, nominated person, or transferee beneficiary; and

(3) does not require the applicant, issuer, nominated person, or transferee beneficiary to recognize the security interest, pay or render performance to the secured party, or accept payment or other performance from the secured party.

Part 5- FILING

SubPart 1 - FILING OFFICE; CONTENTS AND EFFECTIVENESS OF FINANCING STATEMENT

Section 9-501. Filing Office.

(a) Filing offices. Except as otherwise provided in subsection (b), if the law of this state governs perfection of a security interest or agricultural lien, the office in which to file a financing statement to perfect the security interest or agricultural lien is:

(1) the office designated for the filing or recording of a record of a mortgage on the related real property, if:

(A) the collateral is as-extracted collateral or timber to be cut; or

(B) the financing statement is filed as a fixture filing and the collateral is goods that are or are to become fixtures; or

(C) the collateral is a cooperative interest; or

(2) the office of the secretary of state, in all other cases, including a case in which the collateral is goods that are or are to become fixtures and the financing statement is not filed as a fixture filing.

(b) Filing office for transmitting utilities. The office in which to file a financing statement to perfect a security interest in collateral, including fixtures, of a transmitting utility is the office of the secretary of state. The financing statement also constitutes a fixture filing as to the collateral indicated in the financing statement which is or is to become fixtures.

(c) The term "filing officer" or "recording officer" means the county clerk of the county, except in the counties of Bronx, Kings, New York, and Queens where it means the city register in the county; and the term "filing officer" includes the secretary of state where a filing is made in the department of state.

Section 9-502. Contents of Financing Statement; Record of Mortgage as Financing Statement; Time of Filing Financing Statement; Contents of Cooperative Addendum.

(a) Sufficiency of financing statement. Subject to subsection (b), a financing statement is sufficient only if it:

(1) provides the name of the debtor;

(2) provides the name of the secured party or a representative of the secured party;

(3) indicates the collateral covered by the financing statement; and

(4) in the case of a cooperative interest, indicates the number or other designation and the street address of the cooperative unit.

(b) Real-property-related financing statements. Except as otherwise provided in Section 9-501(b), to be sufficient, a financing statement that covers as-extracted collateral or timber to be cut, or which is filed as a fixture filing and covers goods that are or are to become fixtures, or, unless a cooperative addendum is filed, which covers a cooperative interest, must satisfy subsection (a) and also:

(1) indicate that it covers this type of collateral;

(2) indicate that it is to be filed in the real property records;

(3) provide a description of the real property to which the collateral is related, including the location of the real estate by reference to a book and page number in a deed or mortgage index maintained in the county clerk's office in the county where the property is situate or by street and number and town or city, or, if the real estate is in the city of New York, by county, except that if the real estate is in the city of New York or counties of Nassau or Onondaga, where the block system of recording or registering and indexing conveyances is in use, the statement must also specify the block and lot number in which the real estate is situated; and

(4) if the debtor does not have an interest of record in the real property, provide the name of a record owner.

(c) Record of mortgage as financing statement. A record of a mortgage is effective, from the date of recording, as a financing statement filed as a fixture filing or as a financing statement covering as-extracted collateral or timber to be cut only if:

(1) the record indicates the goods or accounts that it covers;

(2) the goods are or are to become fixtures related to the real property described in the record or the collateral is related to the real property described in the record and is as-extracted collateral or timber to be cut;

(3) the record satisfies the requirements for a financing statement in this section, but: (A) the record need not indicate that it is to be filed in the real property records; and (B) the record sufficiently provides the name of a debtor who is an individual if it provides the individual name of the debtor or the surname and first personal name of the debtor, even if the debtor is an individual to whom Section 9-503(a)(4) applies; and

(4) the record is duly recorded.

(d) Filing before security agreement or attachment. A financing statement may be filed before a security agreement is made or a security interest otherwise attaches. (e) Contents of cooperative addendum. A cooperative addendum is sufficient only if it satisfies subsection (a) and also:

(1) if not filed simultaneously with the initial financing statement, identifies, by its file number, the initial financing statement to which the addendum relates;

(2) indicates the street address of the cooperative unit;

(3) indicates the county in which the cooperative unit is located;

(4) indicates the city, town, or village in which the cooperative unit is located;

(5) indicates the real property tax designation associated with the real property in which the cooperative unit is located as assigned by the local real property tax assessing authority; and

(6) indicates the name of the cooperative organization.

Section 9-503. Name of Debtor and Secured Party.

(a) Sufficiency of debtor's name. A financing statement sufficiently provides the name of the debtor:

(1) except as otherwise provided in paragraph (3), if the debtor is a registered organization or the collateral is held in a trust that is a registered organization, only if the financing statement provides the name that is stated to be the registered organization's name on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction of organization which purports to state, amend, or restate the registered organization's name;

(2) subject to subsection (f), if the collateral is being administered by the personal representative of a decedent, only if the financing statement provides, as the name of the debtor, the name of the decedent and, in a separate part of the financing statement, indicates that the collateral is being administered by a personal representative;

(3) if the collateral is held in a trust that is not a registered organization, only if the financing statement:

(A) provides, as the name of the debtor:

(i) if the organic record of the trust specifies a name for the trust, the name specified; or

(ii) if the organic record of the trust does not specify a name for the trust, the name of the settlor or testator; and

(B) in a separate part of the financing statement:

(i) if the name is provided in accordance with subparagraph (A)(i), indicates that the collateral is held in a trust; or

(ii) if the name is provided in accordance with subparagraph (A)(ii), provides additional information sufficient to distinguish the trust from other trusts having one or more of the same settlors or the same testator and indicates that the collateral is held in a trust, unless the additional information so indicates;

(4) subject to subsection (g), if the debtor is an individual to whom this State has issued a driver's license or non-driver photo identification card that has not expired, only if the financing statement provides the name of the individual which is indicated on the driver's license or non-driver photo identification card;

(5) if the debtor is an individual to whom paragraph (4) does not apply, only if the financing statement provides the individual name of the debtor or the surname and first personal name of the debtor; and

(6) in other cases:

(A) if the debtor has a name, only if the financing statement provides the organizational name of the debtor; and

(B) if the debtor does not have a name, only if it provides the names of the partners, members, associates, or other persons comprising the debtor, in a manner that each name provided would be sufficient if the person named were the debtor.

(b) Additional debtor-related information. A financing statement that provides the name of the debtor in accordance with subsection (a) is not rendered ineffective by the absence of:

(1) a trade name or other name of the debtor; or

(2) unless required under subsection (a)(6)(B), names of partners, members, associates, or other persons comprising the debtor.

(c) Debtor's trade name insufficient. A financing statement that provides only the debtor's trade name does not sufficiently provide the name of the debtor.

(d) Representative capacity. Failure to indicate the representative capacity of a secured party or representative of a secured party does not affect the sufficiency of a financing statement.

(e) Multiple debtors and secured parties. A financing statement may provide the name of more than one debtor and the name of more than one secured party.

(f) Name of decedent. The name of the decedent indicated on the order appointing the personal representative of the decedent issued by the court having jurisdiction over the collateral is sufficient as the "name of the decedent" under subsection (a)(2).

(g) Multiple driver's licenses. If this State has issued to an individual more than one driver's license or non-driver photo identification card of a kind described in subsection (a)(4), the one that was issued most recently is the one to which subsection (a)(4) refers.

(h) Definition. In this section, the "name of the settlor or testator" means:

(1) if the settlor is a registered organization, the name that is stated to be the settlor's name on the public organic record most recently filed with or issued or enacted by the settlor's jurisdiction of organization which purports to state, amend, or restate the settlor's name; or

(2) in other cases, the name of the settlor or testator indicated in the trust's organic record.

Section 9-504. Indication of Collateral.

A financing statement sufficiently indicates the collateral that it covers if the financing statement provides: (1) a description of the collateral pursuant to Section 9-108; or (2) an indication that the financing statement covers all assets or all personal property.

Section 9-505. Filing and Compliance with Other Statutes and Treaties for Consignments, Leases, Other Bailments, and Other Transactions.

(a) Use of terms other than "debtor" and "secured party." A consignor, lessor, or other bailor of goods, a licensor, or a buyer of a payment intangible or promissory note may file a financing statement, or may comply with a statute or treaty described in Section 9-311(a), using the terms "consignor", "consignee", "lessor", "lessee", "bailor", "bailee", "licensor", "licensee", "owner", "registered owner", "buyer", "seller", or words of similar import, instead of the terms "secured party" and "debtor".

(b) Effect of financing statement under subsection (a). This part applies to the filing of a financing statement under subsection (a) and, as appropriate, to compliance that is equivalent to filing a financing statement under Section 9-311(b), but the filing or compliance is not of itself a factor in determining whether the collateral secures an obligation. If it is determined for another reason that the collateral secures an obligation, a security interest held by the consignor, lessor, bailor, licensor, owner, or buyer which attaches to the collateral is perfected by the filing or compliance.

Section 9-506. Effect of Errors or Omissions.

(a) Minor errors and omissions. A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.

(b) Financing statement seriously misleading. Except as otherwise provided in subsection (c), a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a) is seriously misleading.

(c) Financing statement not seriously misleading. If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading.

(d) "Debtor's correct name." For purposes of Section 9-508(b), the "debtor's correct name" in subsection (c) means the correct name of the new debtor.

Section 9-507. Effect of Certain Events on Effectiveness of Financing Statement.

(a) Disposition. A filed financing statement remains effective with respect to collateral that is sold, exchanged, leased, licensed, or otherwise disposed of and in which a security interest or agricultural lien continues, even if the secured party knows of or consents to the disposition.

(b) Information becoming seriously misleading. Except as otherwise provided in subsection (c) and Section 9-508, a financing statement is not rendered ineffective if, after the financing statement is filed, the information provided in the financing statement becomes seriously misleading under Section 9-506.

(c) Change in debtor's name. If the name that a filed financing statement provides for a debtor becomes insufficient as the name of the debtor under Section 9-503(a) so that the financing statement becomes seriously misleading under Section 9-506:

(1) the financing statement is effective to perfect a security interest in collateral acquired by the debtor before, or within four months after, the filed financing statement becomes seriously misleading; and

(2) the financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the filed financing statement becomes seriously misleading, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four months after the financing statement became seriously misleading.

Section 9-508. Effectiveness of Financing Statement If New Debtor Becomes Bound by Security Agreement.

(a) Financing statement naming original debtor. Except as otherwise provided in this section, a filed financing statement naming an original debtor is effective to perfect a security interest in collateral in which a new debtor has or acquires rights to the extent that the financing statement would have been effective had the original debtor acquired rights in the collateral.

(b) Financing statement becoming seriously misleading. If the difference between the name of the original debtor and that of the new debtor causes a filed financing statement that is effective under subsection (a) to be seriously misleading under Section 9-506:

(1) the financing statement is effective to perfect a security interest in collateral acquired by the new debtor before, and within four months after, the new debtor becomes bound under Section 9-203(d); and

(2) the financing statement is not effective to perfect a security interest in collateral acquired by the new debtor more than four months after the new debtor becomes bound under Section 9-203(d) unless an initial financing statement providing the name of the new debtor is filed before the expiration of that time. (c) When section not applicable. This section does not apply to collateral as to which a filed financing statement remains effective against the new debtor under Section 9-507(a).

Section 9-509. Persons Entitled to File a Record.

(a) Person entitled to file record. A person may file an initial financing statement, amendment that adds collateral covered by a financing statement, or amendment that adds a debtor to a financing statement only if:

(1) the debtor authorizes the filing in an authenticated record or pursuant to subsection (b) or (c); or

(2) the person holds an agricultural lien that has become effective at the time of filing and the financing statement covers only collateral in which the person holds an agricultural lien.

(b) Security agreement as authorization. By authenticating or becoming bound as debtor by a security agreement, a debtor or new debtor authorizes the filing of an initial financing statement, and an amendment, covering:

(1) the collateral described in the security agreement; and

(2) property that becomes collateral under Section 9-315(a)(2), whether or not the security agreement expressly covers proceeds.

(c) Acquisition of collateral as authorization. By acquiring collateral in which a security interest or agricultural lien continues under Section 9-315(a)(1), a debtor authorizes the filing of an initial financing statement, and an amendment, covering the collateral and property that becomes collateral under Section 9-315(a)(2).

(d) Person entitled to file certain amendments. A person may file an amendment other than an amendment that adds collateral covered by a financing statement or an amendment that adds a debtor to a financing statement only if:

(1) the secured party of record authorizes the filing; or

(2) the amendment is a termination statement for a financing statement as to which the secured party of record has failed to file or send a termination statement as required by Section 9-513(a) or (c), the debtor authorizes the filing, and the termination statement indicates that the debtor authorized it to be filed.

(e) Multiple secured parties of record. If there is more than one secured party of record for a financing statement, each secured party of record may authorize the filing of an amendment under subsection (d).

Section 9-510. Effectiveness of Filed Record.

(a) Filed record effective if authorized. A filed record is effective only to the extent that it was filed by a person that may file it under Section 9-509.

(b) Authorization by one secured party of record. A record authorized by one secured party of record does not affect the financing statement with respect to another secured party of record.

(c) Continuation statement not timely filed. A continuation statement that is not filed within the six-month period prescribed by Section 9-515(d) is ineffective.

Section 9-511. Secured Party of Record.

(a) Secured party of record. A secured party of record with respect to a financing statement is a person whose name is provided as the name of the secured party or a representative of the secured party in an initial financing statement that has been filed. If an initial financing statement is filed under Section 9-514(a), the assignee named in the initial financing statement is the secured party of record with respect to the financing statement.

(b) Amendment naming secured party of record. If an amendment of a financing statement which provides the name of a person as a secured party or a representative of a secured party

is filed, the person named in the amendment is a secured party of record. If an amendment is filed under Section 9-514(b), the assignee named in the amendment is a secured party of record.

(c) Amendment deleting secured party of record. A person remains a secured party of record until the filing of an amendment of the financing statement which deletes the person.

Section 9-512. Amendment of Financing Statement.

(a) Amendment of information in financing statement. Subject to Section 9-509, a person may add or delete collateral covered by, continue or terminate the effectiveness of, or, subject to subsection (e), otherwise amend the information provided in, a financing statement by filing an amendment that:

(1) identifies, by its file number, the initial financing statement to which the amendment relates; and

(2) if the amendment relates to an initial financing statement filed in a filing office described in Section 9-501(a)(1), provides the date and time that the initial financing statement was filed and the information specified in Section 9-502(b).

(b) Period of effectiveness not affected. Except as otherwise provided in Section 9-515, the filing of an amendment does not extend the period of effectiveness of the financing statement.

(c) Effectiveness of amendment adding collateral. A financing statement that is amended by an amendment that adds collateral is effective as to the added collateral only from the date of the filing of the amendment.

(d) Effectiveness of amendment adding debtor. A financing statement that is amended by an amendment that adds a debtor is effective as to the added debtor only from the date of the filing of the amendment.

(e) Certain amendments ineffective. An amendment is ineffective to the extent it:

(1) purports to delete all debtors and fails to provide the name of a debtor to be covered by the financing statement; or

(2) purports to delete all secured parties of record and fails to provide the name of a new secured party of record.

Section 9-513. Termination Statement.

(a) Consumer goods. A secured party shall cause the secured party of record for a financing statement to file a termination statement for the financing statement if the financing statement covers consumer goods and:

(1) there is no obligation secured by the collateral covered by the financing statement and no commitment to make an advance, incur an obligation, or otherwise give value; or

(2) the debtor did not authorize the filing of the initial financing statement.

(b) Time for compliance with subsection (a). To comply with subsection (a), a secured party shall cause the secured party of record to file the termination statement:

(1) within one month after there is no obligation secured by the collateral covered by the financing statement and no commitment to make an advance, incur an obligation, or otherwise give value; or

(2) if earlier, within 20 days after the secured party receives an authenticated demand from a debtor.

(c) Other collateral. In cases not governed by subsection (a), within 20 days after a secured party receives an authenticated demand from a debtor, the secured party shall cause the secured party of record for a financing statement to send to the debtor a termination statement for the financing statement or file the termination statement in the filing office if:

(1) except in the case of a financing statement covering accounts or chattel paper that has been sold or goods that are the subject of a consignment, there is no obligation secured by the collateral covered by the financing statement and no commitment to make an advance, incur an obligation, or otherwise give value;

(2) the financing statement covers accounts or chattel paper that has been sold but as to which the account debtor or other person obligated has discharged its obligation;

(3) the financing statement covers goods that were the subject of a consignment to the debtor but are not in the debtor's possession; or

(4) the debtor did not authorize the filing of the initial financing statement.

(d) Effect of filing termination statement. Except as otherwise provided in Section 9-510, upon the filing of a termination statement with the filing office, the financing statement to which the termination statement relates ceases to be effective. Except as otherwise provided in Section 9-510, for purposes of Section 9-519(g), 9-522(a), and 9-523(c), the filing with the filing office of a termination statement relating to a financing statement that indicates that the debtor is a transmitting utility also causes the effectiveness of the financing statement to lapse.

(e) Cooperative Interests.

(1) "Cooperative Interest Settlement" means the time and place at which an owner of a cooperative interest transfers the cooperative interest, or refinances or pays off the debt secured by the cooperative interest.

(2) Upon an authenticated demand with sufficient notice by a debtor, the secured party shall deliver to a cooperative interest settlement a termination statement or partial release and any component of the cooperative record of which it took possession, which shall be released to the debtor upon payment of the debt secured by the cooperative interest and the discharge of any obligation of the secured party to make further advances. Unless the secured party has agreed otherwise or the cooperative interest settlement takes place at the offices of the secured party, the secured party or its agent shall be entitled to a reasonable fee for attendance at the cooperative interest settlement.

(3) Upon payment of the debt secured by a cooperative interest other than at a cooperative interest settlement and the discharge of any obligation of the secured party to make further advances, the secured party shall arrange for a termination statement or partial release to be filed within one month of receipt of the payment or discharge of the obligation to make further advances, whichever is later, and shall send to the debtor any component of the cooperative record of which it took possession.

Section 9-514. Assignment of Powers of Secured Party of Record.

(a) Assignment reflected on initial financing statement. Except as otherwise provided in subsection (c), an initial financing statement may reflect an assignment of all of the secured party's power to authorize an amendment to the financing statement by providing the name and mailing address of the assignee as the name and address of the secured party.

(b) Assignment of filed financing statement. Except as otherwise provided in subsection (c), a secured party of record may assign of record all or part of its power to authorize an amendment to a financing statement by filing in the filing office an amendment of the financing statement which:

(1) identifies, by its file number, the initial financing statement to which it relates;

(2) provides the name of the assignor; and

(3) provides the name and mailing address of the assignee.

(c) Assignment of record of mortgage. An assignment of record of a security interest in a fixture covered by a record of a mortgage which is effective as a financing statement filed as a fixture filing under Section 9-502(c) may be made only by an assignment of record of the mortgage in the manner provided by law of this state other than this chapter.

Section 9-515. Duration and Effectiveness of Financing Statement; Effect of Lapsed Financing Statement.

(a) Five-year effectiveness. Except as otherwise provided in subsections (b), (e), (f), (g), and (h), a filed financing statement is effective for a period of five years after the date of filing.

(b) Public-financed or manufactured-home transaction. Except as otherwise provided in subsections (e), (f), (g), and (h), an initial financing statement filed in connection with a public-financed transaction or manufactured-home transaction is effective for a period of 30 years after the date of filing if it indicates that it is filed in connection with a public-financed transaction or manufactured-home transaction.

(c) Lapse and continuation of financing statement. The effectiveness of a filed financing statement lapses on the expiration of the period of its effectiveness unless before the lapse a continuation statement is filed pursuant to subsection (d). Upon lapse, a financing statement ceases to be effective and any security interest or agricultural lien that was perfected by the financing statement becomes unperfected, unless the security interest is perfected otherwise. If the security interest or agricultural lien becomes unperfected upon lapse, it is deemed never to have been perfected as against a purchaser of the collateral for value.

(d) When continuation statement may be filed. A continuation statement may be filed only within six months before the expiration of the five-year period specified in subsection (a) or the thirty-year period specified in subsection (b) or the fifty-year period specified in subsection (h), whichever is applicable.

(e) Effect of filing continuation statement. Except as otherwise provided in Section 9-510, upon timely filing of a continuation statement, the effectiveness of the initial financing statement continues for a period of five years commencing on the day on which the financing statement would have become ineffective in the absence of the filing. Upon the expiration of the five-year period, the financing statement lapses in the same manner as provided in subsection (c), unless, before the lapse, another continuation statement is filed pursuant to subsection (d). Succeeding continuation statements may be filed in the same manner to continue the effectiveness of the initial financing statement.

(f) Transmitting utility financing statement. If a debtor is a transmitting utility and a filed initial financing statement so indicates, the financing statement is effective until a termination statement is filed.

(g) Record of mortgage as financing statement. A record of a mortgage that is effective as a financing statement filed as a fixture filing under Section 9-502(c) remains effective as a financing statement filed as a fixture filing until the mortgage is released or satisfied of record or its effectiveness otherwise terminates as to the real property.

(h) Cooperative interest transaction. An initial financing statement covering a cooperative interest is effective for a period of 50 years after the date of the filing of the initial financing statement if a cooperative addendum is filed simultaneously with the initial financing statement or is filed before the financing statement lapses.

Section 9-516. What Constitutes Filing; Effectiveness of Filing.

(a) What constitutes filing. Except as otherwise provided in subsection (b), communication of a record to a filing office and tender of the filing fee or acceptance of the record by the filing office constitutes filing.

(b) Refusal to accept record; filing does not occur. Filing does not occur with respect to a record that a filing office refuses to accept because:

(1) the record is not communicated by a method or medium of communication authorized by the filing office;

(2) an amount equal to or greater than the applicable filing fee is not tendered;

(3) the filing office is unable to index the record because:

(A) in the case of an initial financing statement, the record does not provide a name for the debtor;

(B) in the case of an amendment or correction statement, the record:

(i) does not identify the initial financing statement as required by Section 9-512 or 9-518, as applicable; or

(ii) identifies an initial financing statement whose effectiveness has lapsed under Section 9-515;

(C) in the case of an initial financing statement that provides the name of a debtor identified as an individual or an amendment that provides a name of a debtor identified as an individual which was not previously provided in the financing statement to which the record relates, the record does not identify the debtor's last name; or (

D) in the case of a record filed in the filing office described in Section 9-501 (a) (1), the record does not provide a sufficient description of the real property to which it relates;

(4) in the case of an initial financing statement or an amendment that adds a secured party of record, the record does not provide a name and mailing address for the secured party of record;

(5) in the case of an initial financing statement or an amendment that provides a name of a debtor which was not previously provided in the financing statement to which the amendment relates, the record does not:

(A) provide a mailing address for the debtor; or

(B) indicate whether the debtor is an individual or an organization;

(C) if the financing statement indicates that the debtor is an organization, provide:

(i) a type of organization for the debtor, or

(ii) a jurisdiction of organization for the debtor; or

(6) in the case of an assignment reflected in an initial financing statement under Section 9-514(a) or an amendment filed under Section 9-514(b), the record does not provide a name and mailing address for the assignee; or

(7) in the case of a continuation statement, the record is not filed within the six-month period prescribed by Section 9-515(d).

(c) Rules applicable to subsection (b). For purposes of subsection (b):

(1) a record does not provide information if the filing office is unable to read or decipher the information; and

(2) a record that does not indicate that it is an amendment or identify an initial financing statement to which it relates, as required by Section 9-512, 9-514, or 9-518, is an initial financing statement.

(d) Refusal to accept record; record effective as filed record. A record that is communicated to the filing office with tender of the filing fee, but which the filing office refuses to accept for a reason other than one set forth in subsection (b), is effective as a filed record except as against a purchaser of the collateral which gives value in reasonable reliance upon the absence of the record from the files.

(e) Special rule for cooperative interests; record effective as notice. A filing that includes a cooperative addendum covering a cooperative interest constitutes notice of the existence of the security interest in the cooperative interest as of the date of the filing of the cooperative

addendum, except as against a purchaser of the collateral which gives value in reasonable reliance upon the absence of the record from the files.

Section 9-517. Effect of Indexing Errors.

The failure of the filing office to index a record correctly does not affect the effectiveness of the filed record.

Section 9-518. Claim Concerning Inaccurate or Wrongfully Filed Record.

(a) Correction statement. A person may file in the filing office a correction statement with respect to a record indexed there under the person's name if the person believes that the record is inaccurate or was wrongfully filed.

(b) Sufficiency of correction statement. A correction statement must:

(1) identify the record to which it relates by:

(A) the file number assigned to the initial financing statement to which the record relates; and

(B) if the correction statement relates to a record filed in a filing office described in Section 9-501(a)(1), the date and time that the initial financing statement was filed and the information specified in Section 9-502(b);

(2) indicate that it is a correction statement; and

(3) provide the basis for the person's belief that the record is inaccurate and indicate the manner in which the person believes the record should be amended to cure any inaccuracy or provide the basis for the person's belief that the record was wrongfully filed.

(c) Record not affected by correction statement. The filing of a correction statement does not affect the effectiveness of an initial financing statement or other filed record.

(d) Special proceeding to redact or expunge a falsely filed or amended financing statement.

(1) Provided he or she is an employee of the state or a political subdivision thereof, a person identified as a debtor in a financing statement filed pursuant to this subpart may bring a special proceeding against the named filer of such statement or any amendment thereof to invalidate the filing or amendment thereof where such statement was falsely filed or amended; except that an attorney who is not an employee of the state or a political subdivision thereof may also bring a special proceeding hereunder where he or she represents or has represented the respondent therein in a criminal court. Such special proceeding shall be governed by article four of the civil practice law and rules, and shall be commenced in the supreme court of Albany county, the county of the petitioner's residence or a county within the judicial district in which any property covered by the financing statement is located. No fee pursuant to article eighty of the civil practice law and rules shall be collected in such special proceeding.

(2) The petition in a special proceeding hereunder shall plead that:

(A) the financing statement filed or amended by the respondent pursuant to section 9-509 was falsely filed or amended to retaliate for:

(i) the performance of the petitioner's official duties in his or her capacity as an employee of the state or a political subdivision thereof, or

(ii) in the case of a special proceeding brought by an attorney who is not an employee of the state or a political subdivision thereof, to retaliate for the performance of the petitioner's duties in his or her capacity as an attorney for the respondent in a criminal court; and

(B) such financing statement does not relate to an interest in a consumer-goods transaction, a commercial transaction, or any other actual transaction between the petitioner and the respondent; and

(C) the collateral covered in such financing statement is the property of the petitioner; and

(D) prompt redaction or invalidation of the financing statement is necessary to avert or mitigate prejudice to the petitioner.

(3) If the court makes a written finding that the allegations in paragraph two of this subsection are established, the court shall order the expungement of such statement or its redaction in the public records in the office in which the financing statement is filed, as appropriate, and may grant any additional relief authorized by section 9-625. In such case, the court shall cause a copy of its order to be filed with the secretary of state or other appropriate filing office pursuant to this chapter. Upon a finding that the respondent has engaged in a repeated pattern of false filings as found under this subsection, the court also may enjoin the respondent from filing or amending any further financing statement pursuant to this article without leave of the court. If the respondent is incarcerated at the time the court issues an order containing such an injunction, the court shall cause the head of the correctional facility in which the respondent is incarcerated to receive a copy of such determination. The head of such a facility shall cause a copy of such order to be provided to the respondent. In any instances of the issuance of such an injunction where the respondent has defaulted, the court shall direct service of such injunction upon the respondent.

SubPart 2- DUTIES AND OPERATION OF FILING OFFICE

Section 9-519. Numbering, Maintaining, and Indexing Records; Communicating Information Provided in Records.

(a) Filing office duties. For each record filed in a filing office, the filing office shall:

(1) assign a unique number to the filed record;

(2) create a record that bears the number assigned to the filed record and the date and time of filing;

(3) maintain the filed record for public inspection; and

(4) index the filed record in accordance with subsections (c), (d), and (e).

(b) File number. A file number must include a digit that:

(1) is mathematically derived from or related to the other digits of the file number; and

(2) aids the filing office in determining whether a number communicated as the file number includes a single-digit or transpositional error.

(c) Indexing: general. Except as otherwise provided in subsections (d) and (e), the filing office shall:

(1) index an initial financing statement according to the name of the debtor and index all filed records relating to the initial financing statement in a manner that associates with one another an initial financing statement and all filed records relating to the initial financing statement; and

(2) index a record that provides a name of a debtor which was not previously provided in the financing statement to which the record relates also according to the name that was not previously provided.

(d) Indexing: real-property-related financing statement. If a financing statement is filed as a fixture filing or covers as-extracted collateral, or timber to be cut, or a cooperative interest, the filing office shall index it:

(1) under the names of the debtor and of each owner of record shown on the financing statement as if they were the mortgagors under a mortgage of the real property described; and

(2) to the extent that the law of this state provides for indexing of records of mortgages under the name of the mortgagee, under the name of the secured party as if the secured party were the mortgagee thereunder, and;

(3) if the real estate is in the City of New York or in Nassau, Onondaga, or any other county where the block system of recording or registering and indexing conveyances is in use, according to the block in which the real estate is situated; the filing officer may index such statements according to the names of the record owners of the real estate in a single consolidated index installed and maintained by him pursuant to section five hundred twenty-nine of the county law.

(e) Indexing: real-property-related assignment. If a financing statement is filed as a fixture filing or covers as-extracted collateral, timber to be cut or a cooperative interest, the filing office shall index an assignment filed under Section 9-514(a) or an amendment filed under Section 9-514(b):

(1) under the name of the assignor as grantor; and

(2) to the extent that the law of this state provides for indexing a record of the assignment of a mortgage under the name of the assignee, under the name of the assignee; and

(3) if the real estate is in the City of New York or in Nassau, Onondaga, or any other county where the block system of recording or registering and indexing conveyances is in

use, according to the block in which the real estate is situated; the filing officer may index such assignments according to the names of the record owners of the real estate in a single consolidated index installed and maintained by him pursuant to section five hundred twenty-nine of the county law.

(f) Retrieval and association capability. The filing office shall maintain a capability:

(1) to retrieve a record by the name of the debtor and: (A) if the filing office is described in Section 9-501(a)(1), by the file number assigned to the initial financing statement to which the record relates and the date and time that the record was filed or recorded; or (B) if the filing office is described in Section 9-501(a)(2), by the file number assigned to the initial financing statement to which the record relates; and

(2) to associate and retrieve with one another an initial financing statement and each filed record relating to the initial financing statement; and

(3) if the real estate is in the City of New York or in Nassau, Onondaga, or any other county where the block system of recording or registering and indexing conveyances is in use, to retrieve a record according to the block in which the real estate is situated.

(g) Removal of debtor's name. The filing office may not remove a debtor's name from the index until one year after the effectiveness of a financing statement naming the debtor lapses under Section 9-515 with respect to all secured parties of record.

(h) Timeliness of filing office performance. The filing office shall perform the acts required by subsections (a) through (e) at the time and in the manner prescribed by filing-office rule, but not later than two business days after the filing office receives the record in question.

(i) Inapplicability to real-property-related filing office. Subsections (b) and (h) do not apply to a filing office described in Section 9-501(a)(1).

Section 9-520. Acceptance and Refusal to Accept Record.

(a) Mandatory refusal to accept record. A filing office shall refuse to accept a record for filing for a reason set forth in Section 9-516(b) and may refuse to accept a record for filing only for a reason set forth in Section 9-516(b).

(b) Communication concerning refusal. If a filing office refuses to accept a record for filing, it shall communicate to the person that presented the record the fact of and reason for the refusal and the date and time the record would have been filed had the filing office accepted it. The communication must be made at the time and in the manner prescribed by filing-office rule but, in the case of a filing office described in Section 9-501(a)(2), in no event more than two business days after the filing office receives the record.

(c) When filed financing statement effective. A filed financing statement satisfying Section 9-502(a) and (b) is effective, even if the filing office is required to refuse to accept it for filing under subsection (a). However, Section 9-338 applies to a filed financing statement providing information described in Section 9-516(b)(5) which is incorrect at the time the financing statement is filed.

Section 9-521. Uniform Form of Written Financing Statement; Amendment; and Cooperative Addendum.

(a) Initial financing statement form. A filing office that accepts written records may not refuse to accept a written initial financing statement in the form promulgated by the department of state except for a reason as set forth in Section 9-516(b).

(b) Amendment form. A filing office that accepts written records may not refuse to accept a written financing statement amendment in the form promulgated by the department of state except for a reason as set forth in Section 9-516 (b).

(c) Cooperative addendum form. A filing office that accepts written records may not refuse to accept a written cooperative addendum in the form promulgated by the department of state except for a reason as set forth in Section 9-516 (b).

Section 9-522. Maintenance and Destruction of Records.

(a) Post-lapse maintenance and retrieval of information. The filing office shall maintain a record of the information provided in a filed financing statement for at least one year after the effectiveness of the financing statement has lapsed under Section 9-515 with respect to all secured parties of record. The record must be retrievable by using the name of the debtor and:

(1) if the record was filed in the filing office described in Section 9-501(a)(1), by using: (A) the file number assigned to the initial financing statement to which the record relates and the date and time that the record was filed; and (B) in the case of collateral which is a cooperative interest, the real property tax designation associated with the real property in which the cooperative unit is located as assigned by the local real property tax assessing authority; or

(2) if the record was filed in the filing office described in Section 9-501(a)(2), by using the file number assigned to the initial financing statement to which the record relates.

(b) Destruction of written records. Except to the extent that a statute governing disposition of public records provides otherwise, the filing office immediately may destroy any written record evidencing a financing statement. However, if the filing office destroys a written record, it shall maintain another record of the financing statement which complies with subsection (a).

Section 9-523. Information from Filing Office; Sale or License of Records.

(a) Acknowledgment of filing written record. If a person that files a written record requests an acknowledgment of the filing, the filing office shall send to the person an image of the record showing the number assigned to the record pursuant to Section 9-519(a)(1) and the date and time of the filing of the record. However, if the person furnishes a copy of the record to the filing office, the filing office may instead:

(1) note upon the copy the number assigned to the record pursuant to Section 9-519 (a) (1) and the date and time of the filing of the record; and

(2) send the copy to the person.

(b) Acknowledgment of filing other record. If a person files a record other than a written record, the filing office shall communicate to the person an acknowledgment that provides:

(1) the information in the record;

(2) the number assigned to the record pursuant to Section 9-519(a)(1); and

(3) the date and time of the filing of the record.

(c) Communication of requested information. The filing office shall communicate or otherwise make available in a record the following information to any person that requests it:

(1) whether there is on file on a date and time specified by the filing office, but not a date earlier than three business days before the filing office receives the request, any financing statement that:

(A) designates a particular debtor or, if the request so states, designates a particular debtor at the address specified in the request;

(B) has not lapsed under Section 9-515 with respect to all secured parties of record; and

(C) if the request so states, has lapsed under Section 9-515 and a record of which is maintained by the filing office under Section 9-522(a);

(D) is filed in the filing office described in Section 9-501(a)(1), if the request indicates the real property tax designation associated with the real property as assigned by the local real property tax assessing authority.

(2) the date and time of filing of each financing statement,

(3) the information provided in each financing statement,

(4) whether there is on file any notice of federal tax lien, or a certificate or notice affecting such lien, on the date and time specified in such record naming a particular debtor; and

(5) the date and time of filing of each such notice or certificate of or affecting a federal tax lien.

(d) Medium for communicating information. In complying with its duty under subsection (c), the filing office may communicate information in any medium. However, if requested, the filing office shall communicate information by issuing its written certificate.

(e) Timeliness of filing office performance. The filing office, except by a filing office described in Section 9-501 (a) (1), shall perform the acts required by subsections (a) through (d) at the time and in the manner prescribed by filing-office rule, but not later than two business days after the filing office receives the request.

(f) Public availability of records. At least weekly, the secretary of state shall offer to sell or license to the public on a nonexclusive basis, in bulk, copies of all records filed in it under this part, in every medium from time to time available to the filing office.

Section 9-524. Delay by Filing Office.

Delay by the filing office beyond a time limit prescribed by this part is excused if:

(a) the delay is caused by interruption of communication or computer facilities, war, emergency conditions, failure of equipment, or other circumstances beyond control of the filing office; and

(b) the filing office exercises reasonable diligence under the circumstances.

Section 9-525. Fees.

Fees for filing and services under this chapter shall be determined in accordance with section ninety-six-a of the executive law.

Section 9-526. Filing-office Rules.

(a) Adoption of filing-office rules. The secretary of state shall adopt and publish rules to implement this article. The filing-office rules must be consistent with this article.

(b) Harmonization of rules. To keep the filing-office rules and practices of the filing office in harmony with the rules and practices of filing offices in other jurisdictions that enact substantially this part, and to keep the technology used by the filing office compatible with the technology used by filing offices in other jurisdictions that enact substantially this part, the secretary of state, so far as is consistent with the purposes, policies, and provisions of this article, in adopting, amending, and repealing filing-office rules, shall:

(1) consult with filing offices in other jurisdictions that enact substantially this part; and

(2) consult the most recent version of the Model Rules promulgated by the International Association of Corporate Administrators or any successor organization; and

(3) take into consideration the rules and practices of, and the technology used by, filing offices in other jurisdictions that enact substantially this part.

Section 9-527. Duty to Report.

The secretary of state shall report to the governor, the temporary president of the senate and the speaker of the assembly on the first day of July, two thousand two, on the first day of July, two thousand three and biennially on the first day of July thereafter, on the operation of the filing office. In addition to a statement on the operation of the filing office, the report shall contain a statement of the extent to which:

(a) the filing office rules are not in harmony with the rules of the filing offices in other jurisdictions that enact substantially this part and the reasons for such variation; and

(b) the filing office rules are not in harmony with the most recent version of the Model Rules promulgated by the International Association of Corporate Administrators, or any successor organization, and the reasons for these variations.

Part 6- DEFAULT

SubPart 1 - DEFAULT AND ENFORCEMENT OF SECURITY INTEREST

Section 9-601. Rights after Default; Judicial Enforcement; Consignor or Buyer of Accounts, Chattel Paper, Payment Intangibles, or Promissory Notes.

(a) Rights of secured party after default. After default, a secured party has the rights provided in this part and, except as otherwise provided in Section 9-602, those provided by agreement of the parties. A secured party:

(1) may reduce a claim to judgment, foreclose, or otherwise enforce the claim, security interest, or agricultural lien by any available judicial procedure; and

(2) if the collateral is documents, may proceed either as to the documents or as to the goods they cover.

(b) Rights and duties of secured party in possession or control. A secured party in possession of collateral or control of collateral under Section 7-106, 9-104, 9-105, 9-106, or 9-107 has the rights and duties provided in Section 9-207.

(c) Rights cumulative; simultaneous exercise. The rights under subsections (a) and (b) are cumulative and may be exercised simultaneously.

(d) Rights of debtor and obligor. Except as otherwise provided in subsection (g) and Section 9-605, after default, a debtor and an obligor have the rights provided in this part and by agreement of the parties.

(e) Lien of levy after judgment. If a secured party has reduced its claim to judgment, the lien of any levy that may be made upon the collateral by virtue of an execution based upon the judgment relates back to the earliest of:

(1) the date of perfection of the security interest or agricultural lien in the collateral;

(2) the date of filing a financing statement covering the collateral; or

(3) any date specified in a statute under which the agricultural lien was created.

(f) Execution sale. A sale pursuant to an execution is a foreclosure of the security interest or agricultural lien by judicial procedure within the meaning of this section. A secured party may purchase at the sale and thereafter hold the collateral free of any other requirements of this article.

(g) Consignor or buyer of certain rights to payment. Except as otherwise provided in Section 9-607(c), this part imposes no duties upon a secured party that is a consignor or is a buyer of accounts, chattel paper, payment intangibles, or promissory notes.

Section 9-602. Waiver and Variance of Rights and Duties.

Except as otherwise provided in Section 9-624, to the extent that they give rights to a debtor or obligor and impose duties on a secured party, the debtor or obligor may not waive or vary the rules stated in the following listed sections:

(a) Section 9-207 (b) (4) (C), which deals with use and operation of the collateral by the secured party;

(b) Section 9-210, which deals with requests for an accounting and requests concerning a list of collateral and statement of account; (c) Section 9-607

(c), which deals with collection and enforcement of collateral;

(d) Sections 9-608 (a) and 9-615 (c) to the extent that they deal with application or payment of noncash proceeds of collection, enforcement, or disposition;

(e) Sections 9-608 (a) and 9-615 (d) to the extent that they require accounting for or payment of surplus proceeds of collateral;

(f) Section 9-609 to the extent that it imposes upon a secured party that takes possession of collateral without judicial process the duty to do so without breach of the peace;

(g) Sections 9-610 (b), 9-611, 9-613, and 9-614, which deal with disposition of collateral;

(h) Section 9-615 (f), which deals with calculation of a deficiency or surplus when a disposition is made to the secured party, a person related to the secured party, or a secondary obligor;

(i) Section 9-616, which deals with explanation of the calculation of a surplus or deficiency;

(j) Sections 9-620, 9-621, and 9-622, which deal with acceptance of collateral in satisfaction of obligation;

(k) Section 9-623, which deals with redemption of collateral;

(l) Section 9-624, which deals with permissible waivers; and

(m) Sections 9-625 and 9-626, which deal with the secured party's liability for failure to comply with this article.

Section 9-603. Agreement on Standards Concerning Rights and Duties.

(a) Agreed standards. The parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9-602 if the standards are not manifestly unreasonable.

(b) Agreed standards inapplicable to breach of peace. Subsection (a) does not apply to the duty under Section 9-609 to refrain from breaching the peace.

Section 9-604. Procedure If Security Agreement Covers Real Property, Fixtures, or Cooperative Interests.

(a) Enforcement: personal and real property. If a security agreement covers both personal and real property, a secured party may proceed:

(1) under this part as to the personal property without prejudicing any rights with respect to the real property; or

(2) as to both the personal property and the real property in accordance with the rights with respect to the real property, in which case the other provisions of this part do not apply.

(b) Enforcement: fixtures. Subject to subsection (c), if a security agreement covers goods that are or become fixtures, a secured party may proceed:

(1) under this part; or

(2) in accordance with the rights with respect to real property, in which case the other provisions of this part do not apply.

(c) Removal of fixtures. Subject to the other provisions of this part, if a secured party holding a security interest in fixtures has priority over all owners and encumbrancers of the real property, the secured party, after default, may remove the collateral from the real property.

(d) Injury caused by removal. A secured party that removes collateral shall promptly reimburse any encumbrancer or owner of the real property, other than the debtor, for the cost of repair of any physical injury caused by the removal. The secured party need not reimburse the encumbrancer or owner for any diminution in value of the real property caused by the absence of the goods removed or by any necessity of replacing them. A person entitled to reimbursement may refuse permission to remove until the secured party gives adequate assurance for the performance of the obligation to reimburse.

(e) Enforcement: cooperative interests. A security interest in a cooperative interest may be enforced only as provided in Section 9-601(a).

Section 9-605. Unknown Debtor or Secondary Obligor. A secured party does not owe a duty based on its status as secured party:

(a) to a person that is a debtor or obligor, unless the secured party knows:

(1) that the person is a debtor or obligor;

(2) the identity of the person; and

(3) how to communicate with the person; or

(b) to a secured party or lienholder that has filed a financing statement against a person, unless the secured party knows:

(1) that the person is a debtor; and

(2) the identity of the person.

Section 9-606. Time of Default for Agricultural Lien.

For purposes of this part, a default occurs in connection with an agricultural lien at the time the secured party becomes entitled to enforce the lien in accordance with the statute under which it was created.

Section 9-607. Collection and Enforcement by Secured Party.

(a) Collection and enforcement generally. If so agreed, and in any event after default, a secured party:

(1) may notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party;

(2) may take any proceeds to which the secured party is entitled under Section 9-315;

(3) may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral;

(4) if it holds a security interest in a deposit account perfected by control under Section 9-104 (a) (1), may apply the balance of the deposit account to the obligation secured by the deposit account; and

(5) if it holds a security interest in a deposit account perfected by control under Section 9-104 (a) (2) or (3), may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party.

(b) Nonjudicial enforcement of mortgage. If necessary to enable a secured party to exercise under subsection (a) (3) the right of a debtor to enforce a mortgage nonjudicially, the secured party may record in the office in which a record of the mortgage is recorded:

(1) a copy of the security agreement that creates or provides for a security interest in the obligation secured by the mortgage; and

(2) the secured party's sworn affidavit in recordable form stating that: (A) a default has occurred with respect to the obligation secured by the mortgage; and (B) the secured party is entitled to enforce the mortgage nonjudicially.

(c) Commercially reasonable collection and enforcement. A secured party shall proceed in a commercially reasonable manner if the secured party:

(1) undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral; and

(2) is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor or a secondary obligor.

(d) Expenses of collection and enforcement. A secured party may deduct from the collections made pursuant to subsection (c) reasonable expenses of collection and enforcement, including reasonable attorney's fees and legal expenses incurred by the secured party.

(e) Duties to secured party not affected. This section does not determine whether an account debtor, bank, or other person obligated on collateral owes a duty to a secured party.

Section 9-608. Application of Proceeds of Collection or Enforcement; Liability for Deficiency and Right to Surplus.

(a) Application of proceeds, surplus, and deficiency if obligation secured. If a security interest or agricultural lien secures payment or performance of an obligation, the following rules apply:

(1) A secured party shall apply or pay over for application the cash proceeds of collection or enforcement under Section 9-607 in the following order to:

(A) the reasonable expenses of collection and enforcement and, to the extent provided for by agreement and not prohibited by law, reasonable attorney's fees and legal expenses incurred by the secured party;

(B) the satisfaction of obligations secured by the security interest or agricultural lien under which the collection or enforcement is made; and

(C) the satisfaction of obligations secured by any subordinate security interest in or other lien on the collateral subject to the security interest or agricultural lien under which the collection or enforcement is made if the secured party receives an authenticated demand for proceeds before distribution of the proceeds is completed.

(2) If requested by a secured party, a holder of a subordinate security interest or other lien shall furnish reasonable proof of the interest or lien within a reasonable time. Unless the holder complies, the secured party need not comply with the holder's demand under paragraph (1)(C).

(3) A secured party need not apply or pay over for application noncash proceeds of collection and enforcement under Section 9-607 unless the failure to do so would be commercially unreasonable. A secured party that applies or pays over for application noncash proceeds shall do so in a commercially reasonable manner.

(4) A secured party shall account to and pay a debtor for any surplus, and the obligor is liable for any deficiency.

(b) No surplus or deficiency in sales of certain rights to payment. If the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes, the debtor is not entitled to any surplus, and the obligor is not liable for any deficiency.

Section 9-609. Secured Party's Right to Take Possession after Default.

(a) Possession; rendering equipment unusable; disposition on debtor's premises. After default, a secured party:

(1) may take possession of the collateral; and

(2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises under Section 9-610.

(b) Judicial and nonjudicial process. A secured party may proceed under subsection (a):

(1) pursuant to judicial process; or

(2) without judicial process, if it proceeds without breach of the peace.

(c) Assembly of collateral. If so agreed, and in any event after default, a secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

Section 9-610. Disposition of Collateral after Default.

(a) Disposition after default. After default, a secured party may sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.

(b) Commercially reasonable disposition. Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.

(c) Purchase by secured party. A secured party may purchase collateral:

(1) at a public disposition; or

(2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

(d) Warranties on disposition. A contract for sale, lease, license, or other disposition includes the warranties relating to title, possession, quiet enjoyment, and the like which by operation of law accompany a voluntary disposition of property of the kind subject to the contract.

(e) Disclaimer of warranties. A secured party may disclaim or modify warranties under subsection (d):

(1) in a manner that would be effective to disclaim or modify the warranties in a voluntary disposition of property of the kind subject to the contract of disposition; or

(2) by communicating to the purchaser a record evidencing the contract for disposition and including an express disclaimer or modification of the warranties.

(f) Record sufficient to disclaim warranties. A record is sufficient to disclaim warranties under subsection (e) if it indicates "There is no warranty relating to title, possession, quiet enjoyment, or the like in this disposition" or uses words of similar import.

Section 9-611. Notification Before Disposition of Collateral.

(a) "Notification date." In this section, "notification date" means the earlier of the date on which:

(1) a secured party sends to the debtor and any secondary obligor an authenticated notification of disposition; or

(2) the debtor and any secondary obligor waive the right to notification.

(b) Notification of disposition required. Except as otherwise provided in subsection (d), a secured party that disposes of collateral under Section 9-610 shall send to the persons specified in subsection (c) a reasonable authenticated notification of disposition.

(c) Persons to be notified. To comply with subsection (b), the secured party shall send an authenticated notification of disposition to:

(1) the debtor;

(2) any secondary obligor; and

(3) if the collateral is other than consumer goods:

(A) any other person from which the secured party has received, before the notification date, an authenticated notification of a claim of an interest in the collateral;

(B) any other secured party or lienholder that, 10 days before the notification date, held a security interest in or other lien on the collateral perfected by the filing of a financing statement that:

(i) identified the collateral;

(ii) was indexed under the debtor's name as of that date; and

(iii) was filed in the office in which to file a financing statement against the debtor covering the collateral as of that date; and

(C) any other secured party that, 10 days before the notification date, held a security interest in the collateral perfected by compliance with a statute, regulation, or treaty described in Section 9-311(a).

(d) Subsection (b) inapplicable: perishable collateral; recognized market. Subsection (b) does not apply if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market.

(e) Compliance with subsection (c) (3) (B). A secured party complies with the requirement for notification prescribed by subsection (c) (3) (B) if:

(1) not later than twenty days or earlier than thirty days before the notification date, the secured party requests, in a commercially reasonable manner, information concerning financing statements indexed under the debtor's name in the office indicated in subsection (c) (3) (B); and

(2) before the notification date, the secured party: (A) did not receive a response to the request for information; or (B) received a response to the request for information and sent an authenticated notification of disposition to each secured party or other lienholder named in that response whose financing statement covered the collateral.

(f) Additional pre-disposition notice for cooperative interests.

(1) In addition to such other notification as may be required pursuant to subsection (b) of this section and section 9-613 of this article, a secured party whose collateral consists of a residential cooperative interest used by the debtor and whose security interest in such collateral secures an obligation incurred in connection with financing or refinancing of the acquisition of such cooperative interest and who proposes to dispose of such collateral after a default with respect to such obligation, shall send to the debtor, not less than ninety days prior to the date of the disposition of the cooperative interest, an additional pre-disposition notice as provided herein.

(2) The notice required by this subsection shall be in bold, fourteen-point type and shall be printed on colored paper that is other than the color of the notice required by subsection (b) of this section, and the title of the notice shall be in bold, twenty-point type. The notice shall be on its own page.

(3) The notice required by this subsection shall appear as follows: Help for Homeowners at Risk of Foreclosure New York State Law requires that we send you this information about the foreclosure process. Please read it carefully. Notice You are in danger of losing your home. You are in default of your obligations under the loan secured by your rights to your cooperative apartment. It is important that you take action, if you wish to avoid losing your home. Sources of Information and Assistance The State encourages you to become informed about your options, by seeking assistance from an attorney, a legal aid office, or a government agency or non-profit organization that provides counseling with respect to home foreclosures. To locate a housing counselor near you, you may call the toll-free helpline maintained by the New York State Department of Financial Services at (enter number) or visit the Department's website at (enter web address). One of these persons or organizations may be able to help you, including trying to work with your lender to modify the loan to make it more affordable. Foreclosure rescue scams Be careful of people who approach you with offers to "save" your home. There are individuals who watch for notices of foreclosure actions or collateral sales in order to unfairly profit from a homeowner's distress. You should be extremely careful about any such promises and any suggestions that you pay them a fee or sign any papers that transfer rights of any kind to your cooperative apartment. State law requires anyone offering such services for profit to enter into a contract which fully describes the services they will perform and fees they will charge, and which prohibits them from taking any money from you until they have completed all such promised services.

(4) The department of financial services shall prescribe the telephone number and web address to be included in the notice.

(5) The department of financial services shall post on its website or otherwise make readily available the name and contact information of government agencies or non-profit organizations that may be contacted for information about the foreclosure process, including maintaining a toll-free helpline to disseminate the information required by this subsection.

Section 9-612. Timeliness of Notification Before Disposition of Collateral.

(a) Reasonable time is question of fact. Except as otherwise provided in subsection (b), whether a notification is sent within a reasonable time is a question of fact.

(b) 10-day period sufficient in non-consumer transaction. In a transaction other than a consumer transaction, a notification of disposition sent after default and 10 days or more before the earliest time of disposition set forth in the notification is sent within a reasonable time before the disposition.

Section 9-613. Contents and Form of Notification Before Disposition of Collateral: General.

Except in a consumer-goods transaction, the following rules apply:

(a) The contents of a notification of disposition are sufficient if the notification:

(1) describes the debtor and the secured party;

(2) describes the collateral that is the subject of the intended disposition;

(3) states the method of intended disposition;

(4) states that the debtor is entitled to an accounting of the unpaid indebtedness and states the charge, if any, for an accounting; and

(5) states the time and place of a public disposition or the time after which any other disposition is to be made.

(b) Whether the contents of a notification that lacks any of the information specified in subsection (a) are nevertheless sufficient is a question of fact.

(c) The contents of a notification providing substantially the information specified in subsection (a) are sufficient, even if the notification includes:

(1) information not specified by subsection (a); or

(2) minor errors that are not seriously misleading.

(d) A particular phrasing of the notification is not required.

(e) The following form of notification and the form appearing in Section 9-614(c), when completed, each provides sufficient information:

NOTIFICATION OF DISPOSITION OF COLLATERAL To: (Name of debtor, obligor, or other person to which the notification is sent) From: (Name, address, and telephone number of secured party) Name of Debtor(s): (Include only if debtor(s) are not an addressee) (For a public disposition:) We will sell (or lease or license, as applicable) the (describe collateral) (to the highest qualified bidder) in public as follows: Day and Date: _____ Time: _____ Place: _____ (For a private disposition:) We will sell (or lease or license, as applicable) the (describe collateral) privately sometime after (day and date). You are entitled to an accounting of the unpaid indebtedness secured by the property that we intend to sell (or lease or license, as applicable) (for a charge of $). You may request an accounting by calling us at (telephone number).

Section 9-614. Contents and Form of Notification Before Disposition of Collateral: Consumer-goods Transaction.

In a consumer-goods transaction, the following rules apply:

(a) A notification of disposition must provide the following information:

(1) the information specified in Section 9-613(a);

(2) a description of any liability for a deficiency of the person to which the notification is sent;

(3) a telephone number from which the amount that must be paid to the secured party to redeem the collateral under Section 9-623 is available; and

(4) a telephone number or mailing address from which additional information concerning the disposition and the obligation secured is available.

(b) A particular phrasing of the notification is not required.

(c) The following form of notification, when completed, provides sufficient information:

(Name and address of secured party) (Date) NOTICE OF OUR PLAN TO SELL PROPERTY (Name and address of any obligor who is also a debtor) Subject: (Identification of Transaction) We have your (describe collateral), because you broke promises in our agreement. (For a public disposition:) We will sell (describe collateral) at public sale. A sale could include a lease or license. The sale will be held as follows: Date: _____ Time: _____ Place: _____ You may attend the sale and bring bidders if you want. (For a private disposition:) We will sell (describe collateral) at private sale sometime after (date). A sale could include a lease or license. The money that we get from the sale (after paying our costs) will reduce the amount you owe. If we get less money than you owe, you (will or will not, as applicable) still owe us the difference. If we get more money than you owe, you will get the extra money, unless we must pay it to someone else. You can get the property back at any time before we sell it by paying us the full amount you owe (not just the past due payments), including our expenses. To learn the exact amount you must pay, call us at (telephone number). If you want us to explain to you in writing how we have figured the amount that you owe us, you may call us at (telephone number) (or write us at (secured party's address)) and request a written explanation. (We will charge you $ for the explanation if we sent you another written explanation of the amount you owe us within the last six months.) If you need more information about the sale call us at (telephone number) (or write us at (secured party's address)). We are sending this notice to the following other people who have an interest in (describe collateral) or who owe money under your agreement: (Names of all other debtors and obligors, if any)

(d) A notification in the form of subsection (c) is sufficient, even if additional information appears at the end of the form.

(e) A notification in the form of subsection (c) is sufficient, even if it includes errors in information not required by subsection (a), unless the error is misleading with respect to rights arising under this article.

(f) If a notification under this section is not in the form of subsection (c), law other than this article determines the effect of including information not required by subsection (a).

Section 9-615. Application of Proceeds of Disposition; Liability for Deficiency and Right to Surplus.

(a) Application of proceeds. A secured party shall apply or pay over for application the cash proceeds of disposition under Section 9-610 in the following order to:

(1) the reasonable expenses of retaking, holding, preparing for disposition, processing, and disposing, and, to the extent provided for by agreement and not prohibited by law, reasonable attorney's fees and legal expenses incurred by the secured party;

(1-a) in the case of a cooperative organization security interest, the holder thereof in the amount secured thereby;

(2) the satisfaction of obligations secured by the security interest or agricultural lien under which the disposition is made;

(3) the satisfaction of obligations secured by any subordinate security interest in or other subordinate lien on the collateral if:

(A) the secured party receives from the holder of the subordinate security interest or other lien an authenticated demand for proceeds before distribution of the proceeds is completed; and

(B) in a case in which a consignor has an interest in the collateral, the subordinate security interest or other lien is senior to the interest of the consignor; and

(4) a secured party that is a consignor of the collateral if the secured party receives from the consignor an authenticated demand for proceeds before distribution of the proceeds is completed.

(b) Proof of subordinate interest. If requested by a secured party, a holder of a subordinate security interest or other lien shall furnish reasonable proof of the interest or lien within a reasonable time. Unless the holder does so, the secured party need not comply with the holder's demand under subsection (a) (3).

(c) Application of noncash proceeds. A secured party need not apply or pay over for application noncash proceeds of disposition under Section 9-610 unless the failure to do so would be commercially unreasonable. A secured party that applies or pays over for application noncash proceeds shall do so in a commercially reasonable manner.

(d) Surplus or deficiency if obligation secured. If the security interest under which a disposition is made secures payment or performance of an obligation, after making the payments and applications required by subsection (a) and permitted by subsection (c):

(1) unless subsection (a)(4) requires the secured party to apply or pay over cash proceeds to a consignor, the secured party shall account to and pay a debtor for any surplus; and

(2) the obligor is liable for any deficiency.

(e) No surplus or deficiency in sales of certain rights to payment. If the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes:

(1) the debtor is not entitled to any surplus; and

(2) the obligor is not liable for any deficiency.

(f) Calculation of surplus or deficiency in disposition to person related to secured party. The surplus or deficiency following a disposition is calculated based on the amount of proceeds that would have been realized in a disposition complying with this part to a transferee other than the secured party, a person related to the secured party, or a secondary obligor if:

(1) the transferee in the disposition is the secured party, a person related to the secured party, or a secondary obligor; and

(2) the amount of proceeds of the disposition is significantly below the range of proceeds that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought.

(g) Cash proceeds received by junior secured party. A secured party that receives cash proceeds of a disposition in good faith and without knowledge that the receipt violates the rights of the holder of a security interest or other lien that is not subordinate to the security interest or agricultural lien under which the disposition is made:

(1) takes the cash proceeds free of the security interest or other lien;

(2) is not obligated to apply the proceeds of the disposition to the satisfaction of obligations secured by the security interest or other lien; and

(3) is not obligated to account to or pay the holder of the security interest or other lien for any surplus.

Section 9-616. Explanation of Calculation of Surplus or Deficiency.

(a) Definitions. In this section:

(1) "Explanation" means a writing that:

(A) states the amount of the surplus or deficiency;

(B) provides an explanation in accordance with subsection (c) of how the secured party calculated the surplus or deficiency;

(C) states, if applicable, that future debits, credits, charges, including additional credit service charges or interest, rebates, and expenses may affect the amount of the surplus or deficiency; and

(D) provides a telephone number or mailing address from which additional information concerning the transaction is available.

(2) "Request" means a record:

(A) authenticated by a debtor or consumer obligor;

(B) requesting that the recipient provide an explanation; and

(C) sent after disposition of the collateral under Section 9-610.

(b) Explanation of calculation. In a consumer-goods transaction in which the debtor is entitled to a surplus or a consumer obligor is liable for a deficiency under Section 9-615, the secured party shall:

(1) send an explanation to the debtor or consumer obligor, as applicable, after the disposition and: (A) before or when the secured party accounts to the debtor and pays any surplus or first makes written demand on the consumer obligor after the disposition for payment of the deficiency; and (B) within fourteen days after receipt of a request; or

(2) in the case of a consumer obligor who is liable for a deficiency, within fourteen days after receipt of a request, send to the consumer obligor a record waiving the secured party's right to a deficiency.

(c) Required information. To comply with subsection (a)(1)(B), a writing must provide the following information in the following order:

(1) the aggregate amount of obligations secured by the security interest under which the disposition was made, and, if the amount reflects a rebate of unearned interest or credit service charge, an indication of that fact, calculated as of a specified date:

(A) if the secured party takes or receives possession of the collateral after default, not more than thirty-five days before the secured party takes or receives possession; or

(B) if the secured party takes or receives possession of the collateral before default or does not take possession of the collateral, not more than thirty-five days before the disposition;

(2) the amount of proceeds of the disposition;

(3) the aggregate amount of the obligations after deducting the amount of proceeds;

(4) the amount, in the aggregate or by type, and types of expenses, including expenses of retaking, holding, preparing for disposition, processing, and disposing of the collateral, and attorney's fees secured by the collateral which are known to the secured party and relate to the current disposition;

(5) the amount, in the aggregate or by type, and types of credits, including rebates of interest or credit service charges, to which the obligor is known to be entitled and which are not reflected in the amount in paragraph (1); and

(6) the amount of the surplus or deficiency.

(d) Substantial compliance. A particular phrasing of the explanation is not required. An explanation complying substantially with the requirements of subsection (a) is sufficient, even if it includes minor errors that are not seriously misleading.

(e) Charges for responses. A debtor or consumer obligor is entitled without charge to one response to a request under this section during any six-month period in which the secured party did not send to the debtor or consumer obligor an explanation pursuant to subsection (b)(1). The secured party may require payment of a charge not exceeding 25 dollars for each additional response.

Section 9-617. Rights of Transferee of Collateral.

(a) Effects of disposition. A secured party's disposition of collateral after default:

(1) transfers to a transferee for value all of the debtor's rights in the collateral;

(2) discharges the security interest under which the disposition is made; and

(3) discharges any subordinate security interest or other subordinate lien other than liens created under any law of this state that are not to be discharged.

(b) Rights of good-faith transferee. A transferee that acts in good faith takes free of the rights and interests described in subsection (a), even if the secured party fails to comply with this article or the requirements of any judicial proceeding.

(c) Rights of other transferee. If a transferee does not take free of the rights and interests described in subsection (a), the transferee takes the collateral subject to:

(1) the debtor's rights in the collateral;

(2) the security interest or agricultural lien under which the disposition is made; and

(3) any other security interest or other lien.

Section 9-618. Rights and Duties of Certain Secondary Obligors.

(a) Rights and duties of secondary obligor. A secondary obligor acquires the rights and becomes obligated to perform the duties of the secured party after the secondary obligor:

(1) receives an assignment of a secured obligation from the secured party;

(2) receives a transfer of collateral from the secured party and agrees to accept the rights and assume the duties of the secured party; or

(3) is subrogated to the rights of a secured party with respect to collateral.

(b) Effect of assignment, transfer, or subrogation. An assignment, transfer, or subrogation described in subsection (a):

(1) is not a disposition of collateral under Section 9-610; and

(2) relieves the secured party of further duties under this article.

Section 9-619. Transfer of Record or Legal Title.

(a) "Transfer statement." In this section, "transfer statement" means a record authenticated by a secured party stating:

(1) that the debtor has defaulted in connection with an obligation secured by specified collateral;

(2) that the secured party has exercised its post-default remedies with respect to the collateral;

(3) that, by reason of the exercise, a transferee has acquired the rights of the debtor in the collateral; and

(4) the name and mailing address of the secured party, debtor, and transferee.

(b) Effect of transfer statement. A transfer statement entitles the transferee to the transfer of record of all rights of the debtor in the collateral specified in the statement in any official filing, recording, registration, or certificate-of-title system covering the collateral. If a transfer statement is presented with the applicable fee and request form to the official or office responsible for maintaining the system, the official or office shall:

(1) accept the transfer statement;

(2) promptly amend its records to reflect the transfer; and

(3) if applicable, issue a new appropriate certificate of title in the name of the transferee.

(c) Transfer not a disposition; no relief of secured party's duties. A transfer of the record or legal title to collateral to a secured party under subsection (b) or otherwise is not of itself a disposition of collateral under this article and does not of itself relieve the secured party of its duties under this article.

Section 9-620. Acceptance of Collateral in Full or Partial Satisfaction of Obligation; Compulsory Disposition of Collateral.

(a) Conditions to acceptance in satisfaction. Except as otherwise provided in subsections (g) and (h), a secured party may accept collateral in full or partial satisfaction of the obligation it secures only if:

(1) the debtor consents to the acceptance under subsection (c);

(2) the secured party does not receive, within the time set forth in subsection (d), a notification of objection to the proposal authenticated by: (A) a person to which the secured party was required to send a proposal under Section 9-621; or (B) any other person, other than the debtor, holding an interest in the collateral subordinate to the security interest that is the subject of the proposal;

(3) if the collateral is consumer goods, the collateral is not in the possession of the debtor when the debtor consents to the acceptance; and

(4) subsection (e) does not require the secured party to dispose of the collateral or the debtor waives the requirement pursuant to Section 9-624.

(b) Purported acceptance ineffective. A purported or apparent acceptance of collateral under this section is ineffective unless:

(1) the secured party consents to the acceptance in an authenticated record or sends a proposal to the debtor; and

(2) the conditions of subsection (a) are met.

(c) Debtor's consent. For purposes of this section:

(1) a debtor consents to an acceptance of collateral in partial satisfaction of the obligation it secures only if the debtor agrees to the terms of the acceptance in a record authenticated after default; and

(2) a debtor consents to an acceptance of collateral in full satisfaction of the obligation it secures only if the debtor agrees to the terms of the acceptance in a record authenticated after default or the secured party:

(A) sends to the debtor after default a proposal that is unconditional or subject only to a condition that collateral not in the possession of the secured party be preserved or maintained;

(B) in the proposal, proposes to accept collateral in full satisfaction of the obligation it secures; and

(C) does not receive a notification of objection authenticated by the debtor within twenty days after the proposal is sent.

(d) Effectiveness of notification. To be effective under subsection (a)(2), a notification of objection must be received by the secured party:

(1) in the case of a person to which the proposal was sent pursuant to Section 9-621, within 20 days after notification was sent to that person; and

(2) in other cases:

(A) within 20 days after the last notification was sent pursuant to Section 9-621; or

(B) if a notification was not sent, before the debtor consents to the acceptance under subsection (c).

(e) Mandatory disposition of consumer goods. A secured party that has taken possession of collateral shall dispose of the collateral pursuant to Section 9-610 within the time specified in subsection (f) if:

(1) sixty percent of the cash price has been paid in the case of a purchase-money security interest in consumer goods; or

(2) sixty percent of the principal amount of the obligation secured has been paid in the case of a non-purchase-money security interest in consumer goods.

(f) Compliance with mandatory disposition requirement. To comply with subsection (e), the secured party shall dispose of the collateral:

(1) within 90 days after taking possession; or

(2) within any longer period to which the debtor and all secondary obligors have agreed in an agreement to that effect entered into and authenticated after default.

(g) No partial satisfaction in consumer transaction. In a consumer transaction, a secured party may not accept collateral in partial satisfaction of the obligation it secures.

(h) Special provisions for cooperative interests. A secured party whose collateral consists of a residential cooperative interest used by the debtor and whose security interest in such collateral secures an obligation incurred in connection with financing or refinancing of the acquisition of such cooperative interest and who chooses to accept that cooperative interest in full satisfaction of the debtor's obligation may do so.

(1) If the secured party sends a proposal to take the cooperative interest in full satisfaction of the debtor's obligation, the proposal shall be accompanied by a notice in the form and manner prescribed in subsection (f) of section 9-611 of this subpart, unless the secured party has previously sent the debtor such notice. A debtor consents to an acceptance of a cooperative interest in full satisfaction of the obligation it secures only if the debtor agrees to the terms of the proposal in a record authenticated after default.

(2) A debtor may propose to the secured party that it take the cooperative interest in full satisfaction of the obligation it secures. The proposal shall be ineffective unless the secured party consents to the proposal in an authenticated record.

Section 9-621. Notification of Proposal to Accept Collateral.

(a) Persons to which proposal to be sent. A secured party that desires to accept collateral in full or partial satisfaction of the obligation it secures shall send its proposal to:

(1) any person from which the secured party has received, before the debtor consented to the acceptance, an authenticated notification of a claim of an interest in the collateral;

(2) any other secured party or lienholder that, 10 days before the debtor consented to the acceptance, held a security interest in or other lien on the collateral perfected by the filing of a financing statement that: (A) identified the collateral; (B) was indexed under the debtor's name as of that date; and (C) was filed in the office or offices in which to file a financing statement against the debtor covering the collateral as of that date; and

(3) any other secured party that, 10 days before the debtor consented to the acceptance, held a security interest in the collateral perfected by compliance with a statute, regulation, or treaty described in Section 9-311(a).

(b) Proposal to be sent to secondary obligor in partial satisfaction. A secured party that desires to accept collateral in partial satisfaction of the obligation it secures shall send its proposal to any secondary obligor in addition to the persons described in subsection (a).

Section 9-622. Effect of Acceptance of Collateral.

(a) Effect of acceptance. A secured party's acceptance of collateral in full or partial satisfaction of the obligation it secures:

(1) discharges the obligation to the extent consented to by the debtor;

(2) transfers to the secured party all of a debtor's rights in the collateral;

(3) discharges the security interest or agricultural lien that is the subject of the debtor's consent and any subordinate security interest or other subordinate lien; and

(4) terminates any other subordinate interest.

(b) Discharge of subordinate interest notwithstanding noncompliance. A subordinate interest is discharged or terminated under subsection (a), even if the secured party fails to comply with this article.

Section 9-623. Right to Redeem Collateral.

(a) Persons that may redeem. A debtor, any secondary obligor, or any other secured party or lienholder may redeem collateral.

(b) Requirements for redemption. To redeem collateral, a person shall tender:

(1) fulfillment of all obligations secured by the collateral; and

(2) the reasonable expenses and attorney's fees described in Section 9-615(a)(1).

(c) When redemption may occur. A redemption may occur at any time before a secured party:

(1) has collected collateral under Section 9-607;

(2) has disposed of collateral or entered into a contract for its disposition under Section 9-610; or

(3) has accepted collateral in full or partial satisfaction of the obligation it secures under Section 9-622.

Section 9-624. Waiver.

(a) Waiver of disposition notification. A debtor or secondary obligor may waive the right to notification of disposition of collateral under Section 9-611 only by an agreement to that effect entered into and authenticated after default.

(b) Waiver of mandatory disposition. A debtor may waive the right to require disposition of collateral under Section 9-620 (e) only by an agreement to that effect entered into and authenticated after default.

(c) Waiver of redemption right. Except in a consumer-goods transaction, a debtor or secondary obligor may waive the right to redeem collateral under Section 9-623 only by an agreement to that effect entered into and authenticated after default.

SubPart 2- NONCOMPLIANCE WITH ARTICLE

Section 9-625. Remedies for Secured Party's Failure to Comply with Article.

(a) Judicial orders concerning noncompliance. If it is established that a secured party is not proceeding in accordance with this article, a court may order or restrain collection, enforcement, or disposition of collateral on appropriate terms and conditions.

(b) Damages for noncompliance. Subject to subsections (c), (d), and (f), a person is liable for damages in the amount of any loss caused by a failure to comply with this article. Loss caused by a failure to comply may include loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing.

(c) Persons entitled to recover damages; statutory damages if collateral is consumer goods. Except as otherwise provided in Section 9-628:

(1) a person that, at the time of the failure, was a debtor, was an obligor, or held a security interest in or other lien on the collateral may recover damages under subsection (b) for its loss; and

(2) if the collateral is consumer goods, a person that was a debtor or a secondary obligor at the time a secured party failed to comply with this part may recover for that failure in any event an amount not less than the credit service charge plus 10 percent of the principal amount of the obligation or the time-price differential plus 10 percent of the cash price.

(d) Recovery when deficiency eliminated or reduced. A debtor whose deficiency is eliminated under Section 9-626 may recover damages for the loss of any surplus. However, a debtor or secondary obligor whose deficiency is eliminated or reduced under Section 9-626 may not otherwise recover under subsection (b) for noncompliance with the provisions of this part relating to collection, enforcement, disposition, or acceptance.

(e) Statutory damages: noncompliance with specified provisions. In addition to any damages recoverable under subsection (b), the debtor, consumer obligor, or person named as a debtor in a filed record, as applicable, may recover five hundred dollars in each case from a person that:

(1) fails to comply with Section 9-208;

(2) fails to comply with Section 9-209;

(3) files a record that the person is not entitled to file under Section 9-509 (a);

(4) fails to cause the secured party of record to file or send a termination statement as required by Section 9-513 (a), (c), or (e);

(5) fails to comply with Section 9-616 (b) (1) and whose failure is part of a pattern, or consistent with a practice, of noncompliance; or

(6) fails to comply with Section 9-616 (b) (2).

(f) Statutory damages: noncompliance with Section 9-210. A debtor or consumer obligor may recover damages under subsection (b) and, in addition, five hundred dollars in each case from a person that, without reasonable cause, fails to comply with a request under Section 9-210. A recipient of a request under Section 9-210 which never claimed an interest in the collateral or obligations that are the subject of a request under that section has a reasonable excuse for failure to comply with the request within the meaning of this subsection.

(g) Limitation of security interest: noncompliance with Section 9-210. If a secured party fails to comply with a request regarding a list of collateral or a statement of account under Section 9-210, the secured party may claim a security interest only as shown in the list or statement included in the request as against a person that is reasonably misled by the failure.

Section 9-626. Action in Which Deficiency or Surplus is in Issue.

(a) Applicable rules if amount of deficiency or surplus is in issue. In an action arising from a transaction, other than a consumer transaction, in which the amount of a deficiency or surplus is in issue, the following rules apply:

(1) A secured party need not prove compliance with the provisions of this part relating to collection, enforcement, disposition, or acceptance unless the debtor or a secondary obligor places the secured party's compliance in issue.

(2) If the secured party's compliance is placed in issue, the secured party has the burden of establishing that the collection, enforcement, disposition, or acceptance was conducted in accordance with this part.

(3) Except as otherwise provided in Section 9-628, if a secured party fails to prove that the collection, enforcement, disposition, or acceptance was conducted in accordance with the provisions of this part relating to collection, enforcement, disposition, or acceptance, the liability of a debtor or a secondary obligor for a deficiency is limited to an amount by which the sum of the secured obligation, expenses, and attorney's fees exceeds the greater of:

(A) the proceeds of the collection, enforcement, disposition, or acceptance; or

(B) the amount of proceeds that would have been realized had the noncomplying secured party proceeded in accordance with the provisions of this part relating to collection, enforcement, disposition, or acceptance.

(4) For purposes of paragraph (3)(B), the amount of proceeds that would have been realized is equal to the sum of the secured obligation, expenses, and attorney's fees unless the secured party proves that the amount is less than that sum.

(5) If a deficiency or surplus is calculated under Section 9-615(f), the debtor or obligor has the burden of establishing that the amount of proceeds of the disposition is significantly below the range of prices that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought.

(b) Non-consumer transactions; no inference. The limitation of the rules in subsection (a) to transactions other than consumer transactions is intended to leave to the court the determination of the proper rules in consumer transactions. The court may not infer from that limitation the nature of the proper rule in consumer transactions and may continue to apply established approaches.

Section 9-627. Determination of Whether Conduct Was Commercially Reasonable.

(a) Greater amount obtainable under other circumstances; no preclusion of commercial reasonableness. The fact that a greater amount could have been obtained by a collection, enforcement, disposition, or acceptance at a different time or in a different method from that selected by the secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition, or acceptance was made in a commercially reasonable manner.

(b) Dispositions that are commercially reasonable. A disposition of collateral is made in a commercially reasonable manner if the disposition is made:

(1) in the usual manner on any recognized market;

(2) at the price current in any recognized market at the time of the disposition; or

(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

(c) Approval by court or on behalf of creditors. A collection, enforcement, disposition, or acceptance is commercially reasonable if it has been approved:

(1) in a judicial proceeding;

(2) by a bona fide creditors' committee;

(3) by a representative of creditors; or

(4) by an assignee for the benefit of creditors.

(d) Approval under subsection (c) not necessary; absence of approval has no effect. Approval under subsection (c) need not be obtained, and lack of approval does not mean that the collection, enforcement, disposition, or acceptance is not commercially reasonable.

Section 9-628. Nonliability and Limitation on Liability of Secured Party; Liability of Secondary Obligor.

(a) Limitation of liability of secured party for noncompliance with article. Unless a secured party knows that a person is a debtor or obligor, knows the identity of the person, and knows how to communicate with the person:

(1) the secured party is not liable to the person, or to a secured party or lienholder that has filed a financing statement against the person, for failure to comply with this article; and

(2) the secured party's failure to comply with this article does not affect the liability of the person for a deficiency.

(b) Limitation of liability based on status as secured party. A secured party is not liable because of its status as secured party:

(1) to a person that is a debtor or obligor, unless the secured party knows:

(A) that the person is a debtor or obligor;

(B) the identity of the person; and

(C) how to communicate with the person; or

(2) to a secured party or lienholder that has filed a financing statement against a person, unless the secured party knows:

(A) that the person is a debtor; and

(B) the identity of the person.

(c) Limitation of liability if reasonable belief that transaction not a consumer-goods transaction or consumer transaction. A secured party is not liable to any person, and a person's liability for a deficiency is not affected, because of any act or omission arising out of the secured party's reasonable belief that a transaction is not a consumer-goods transaction or a consumer transaction or that goods are not consumer goods, if the secured party's belief is based on its reasonable reliance on:

(1) a debtor's representation concerning the purpose for which collateral was to be used, acquired, or held; or

(2) an obligor's representation concerning the purpose for which a secured obligation was incurred.

(d) Limitation of liability for statutory damages. A secured party is not liable to any person under Section 9-625 (c) (2) for its failure to comply with Section 9-616.

(e) Limitation of multiple liability for statutory damages. A secured party is not liable under Section 9-625 (c) (2) more than once with respect to any one secured obligation.

Part 7 – TRANSITION

Section 9-700. Definitions.

The following words and terms when used in this part 7 shall have the following meanings:

"Former Article 9." The provisions of article 9 of the Uniform Commercial Code of this state as in effect before the effective date of Revised Article 9.

"Revised Article 9." The provisions of article 9 of the Uniform Commercial Code of this state, as amended by the chapter of the laws of 2001 which added these words and as they may be further amended.

Section 9-701. Effective Date.

Revised Article 9 takes effect on July 1, 2001.

Section 9-702. Savings Clause.

(a) Pre-effective-date transactions or liens. Except as otherwise provided in this part, Revised Article 9 applies to a transaction or lien within its scope, even if the transaction or lien was entered into or created before Revised Article 9 takes effect.

(b) Continuing validity. Except as otherwise provided in subsection (c) and Sections 9-703 through 9-709:

(1) transactions and liens that were not governed by Former Article 9, were validly entered into or created before Revised Article 9 takes effect, and would be subject to Revised Article 9 if they had been entered into or created after Revised Article 9 takes effect, and the rights, duties, and interests flowing from those transactions and liens remain valid after Revised Article 9 takes effect; and

(2) the transactions and liens may be terminated, completed, consummated, and enforced as required or permitted by Revised Article 9 or by the law that otherwise would apply if Revised Article 9 had not taken effect.

(c) Pre-effective-date proceedings. Revised Article 9 does not affect an action, case, or proceeding commenced before Revised Article 9 takes effect.

Section 9-703. Security Interest Perfected Before Effective Date.

(a) Continuing priority over lien creditor: perfection requirements satisfied. A security interest that is enforceable immediately before Revised Article 9 takes effect and would have priority over the rights of a person that becomes a lien creditor at that time is a perfected security interest under Revised Article 9 if, when Revised Article 9 takes effect, the applicable requirements for enforceability and perfection under Revised Article 9 are satisfied without further action.

(b) Continuing priority over lien creditor: perfection requirements not satisfied. Except as otherwise provided in Section 9-705 and subsection (c), if, immediately before this article takes effect, a security interest is enforceable and would have priority over the rights of a person that becomes a lien creditor at that time, but the applicable requirements for enforceability or perfection under this article are not satisfied when this article takes effect, the security interest:

(1) is a perfected security interest for one year after this article takes effect;

(2) remains enforceable thereafter only if the security interest becomes enforceable under Section 9-203 before the year expires; and

(3) remains perfected thereafter only if the applicable requirements for perfection under this article are satisfied before the year expires.

(c) Special rule for cooperative interests: perfection requirements not satisfied. If, immediately before Revised Article 9 takes effect, a security interest in a cooperative interest is enforceable and would have priority over the rights of a person that becomes a lien creditor at that time, but the applicable requirements for perfection under Revised Article 9 are not satisfied when Revised Article 9 takes effect, the security interest:

(1) is a perfected security interest for 5 years after Revised Article 9 takes effect; and

(2) remains perfected thereafter only if the applicable requirements for perfection under Revised Article 9 are satisfied before the 5 years expire.

Section 9-704. Security Interest Unperfected Before Effective Date.

A security interest that is enforceable immediately before Revised Article 9 takes effect but which would be subordinate to the rights of a person that becomes a lien creditor at that time:

(a) remains an enforceable security interest for one year after Revised Article 9 takes effect;

(b) remains enforceable thereafter if the security interest becomes enforceable under Section 9-203 when Revised Article 9 takes effect or within one year thereafter; and

(c) becomes perfected:

(1) without further action, when Revised Article 9 takes effect if the applicable requirements for perfection under Revised Article 9 are satisfied before or at that time; or

(2) when the applicable requirements for perfection are satisfied if the requirements are satisfied after that time.

Section 9-705. Effectiveness of Action Taken Before Effective Date.

(a) Pre-effective-date action; one-year perfection period unless reperfected. If action, other than the filing of a financing statement, is taken before Revised Article 9 takes effect and the action would have resulted in priority of a security interest over the rights of a person that becomes a lien creditor had the security interest become enforceable before Revised Article 9 takes effect, the action is effective to perfect a security interest that attaches under Revised Article 9 within one year after Revised Article 9 takes effect. An attached security interest becomes unperfected one year after Revised Article 9 takes effect unless the security interest becomes a perfected security interest under Revised Article 9 before the expiration of that period.

(b) Pre-effective-date filing. The filing of a financing statement before Revised Article 9 takes effect is effective to perfect a security interest to the extent the filing would satisfy the applicable requirements for perfection under Revised Article 9.

(c) Pre-effective-date filing in jurisdiction formerly governing perfection. Revised Article 9 does not render ineffective an effective financing statement that, before Revised Article 9 takes effect, is filed and satisfies the applicable requirements for perfection under the law of the jurisdiction governing perfection as provided in Former Section 9-103. However, except as otherwise provided in subsections (d) and (e) and Section 9-706, the financing statement ceases to be effective at the earlier of:

(1) the time the financing statement would have ceased to be effective under the law of the jurisdiction in which it is filed; or

(2) June thirtieth, 2006.

(d) Continuation statement. The filing of a continuation statement after Revised Article 9 takes effect does not continue the effectiveness of the financing statement filed before

Revised Article 9 takes effect. However, upon the timely filing of a continuation statement after Revised Article 9 takes effect and in accordance with the law of the jurisdiction governing perfection as provided in Part 3, the effectiveness of a financing statement filed in the same office in that jurisdiction before Revised Article 9 takes effect continues for the period provided by the law of that jurisdiction.

(e) Application of subsection (c) (2) to transmitting utility financing statement. Subsection (c) (2) applies to a financing statement that, before Revised Article 9 takes effect, is filed against a transmitting utility and satisfies the applicable requirements for perfection under the law of the jurisdiction governing perfection as provided in Former Section 9-103 only to the extent that Part 3 provides that the law of a jurisdiction other than the jurisdiction in which the financing statement is filed governs perfection of a security interest in collateral covered by the financing statement.

(f) Application of Part 5. A financing statement that includes a financing statement filed before Revised Article 9 takes effect and a continuation statement filed after Revised Article 9 takes effect is effective only to the extent that it satisfies the requirements of Part 5 for an initial financing statement.

Section 9-706. When Initial Financing Statement Suffices to Continue Effectiveness of Financing Statement.

(a) Initial financing statement in lieu of continuation statement. The filing of an initial financing statement in the office specified in Section 9-501 continues the effectiveness of a financing statement filed before Revised Article 9 takes effect if:

(1) the filing of an initial financing statement in that office would be effective to perfect a security interest under Revised Article 9;

(2) the pre-effective-date financing statement was filed in an office in another state or another office in this state; and

(3) the initial financing statement satisfies subsection (c).

(b) Period of continued effectiveness. The filing of an initial financing statement under subsection (a) continues the effectiveness of the pre-effective-date financing statement:

(1) if the initial financing statement is filed before Revised Article 9 takes effect, for the period provided in Former Section 9-403 with respect to a financing statement; and

(2) if the initial financing statement is filed after Revised Article 9 takes effect, for the period provided in Section 9-515 with respect to an initial financing statement.

(c) Requirements for initial financing statement under subsection (a). To be effective for purposes of subsection (a), an initial financing statement must:

(1) satisfy the requirements of Part 5 for an initial financing statement;

(2) identify the pre-effective-date financing statement by indicating the office in which the financing statement was filed and providing the dates of filing and file numbers, if

any, of the financing statement and of the most recent continuation statement filed with respect to the financing statement; and

(3) indicate that the pre-effective-date financing statement remains effective.

Section 9-707. Amendment of Pre-effective-date Financing Statement.

(a) "Pre-effective-date financing statement". In this section, "pre-effective-date financing statement" means a financing statement filed before Revised Article 9 takes effect.

(b) Applicable law. After Revised Article 9 takes effect, a person may add or delete collateral covered by, continue or terminate the effectiveness of, or otherwise amend the information provided in, a pre-effective-date financing statement only in accordance with the law of the jurisdiction governing perfection as provided in Part 3. However, the effectiveness of a pre-effective-date financing statement also may be terminated in accordance with the law of the jurisdiction in which the financing statement is filed.

(c) Method of amending: general rule. Except as otherwise provided in subsection (d), if the law of this state governs perfection of a security interest, the information in a pre-effective-date financing statement may be amended after Revised Article 9 takes effect only if:

(1) the pre-effective-date financing statement and an amendment are filed in the office specified in Section 9-501;

(2) an amendment is filed in the office specified in Section 9-501 concurrently with, or after the filing in that office of, an initial financing statement that satisfies Section 9-706 (c); or

(3) an initial financing statement that provides the information as amended and satisfies Section 9-706 (c) is filed in the office specified in Section 9-501.

(d) Method of amending: continuation. If the law of this state governs perfection of a security interest, the effectiveness of a pre-effective-date financing statement may be continued only under Section 9-705 (d) and (f) or 9-706.

(e) Method of amending: additional termination rule. Whether or not the law of this state governs perfection of a security interest, the effectiveness of a pre-effective-date financing statement filed in this state may be terminated after Revised Article 9 takes effect by filing a termination statement in the office in which the pre-effective-date financing statement is filed, unless an initial financing statement that satisfies Section 9-706 (c) has been filed in the office specified by the law of the jurisdiction governing perfection as provided in Part 3 as the office in which to file a financing statement.

Section 9-708. Persons Entitled to File Initial Financing Statement or Continuation Statement.

A person may file an initial financing statement or a continuation statement under this part if:

(a) the secured party of record authorizes the filing; and (b) the filing is necessary under this part:

(1) to continue the effectiveness of a financing statement filed before Revised Article 9 takes effect; or

(2) to perfect or continue the perfection of a security interest.

Section 9-709. Priority.

(a) Law governing priority. Revised Article 9 determines the priority of conflicting claims to collateral. However, if the relative priorities of the claims were established before Revised Article 9 takes effect, Former Article 9 determines priority.

(b) Priority if security interest becomes enforceable under Section 9-203. For purposes of Section 9-322(a), the priority of a security interest that becomes enforceable under Section 9-203 of Revised Article 9 dates from the time Revised Article 9 takes effect if the security interest is perfected under Revised Article 9 by the filing of a financing statement before Revised Article 9 takes effect which would not have been effective to perfect the security interest under Former Article 9. This subsection does not apply to conflicting security interests each of which is perfected by the filing of such a financing statement.

Section 9-710. Transitional Provision for Maintaining and Searching Local-Filing Office Records.

(a) In this Section:

(1) "Local-filing office" means a filing office, other than the department of state, that is designated as the proper place to file a financing statement under Section 9-401 of Former Article 9. The term applies only with respect to a record that covers a type of collateral as to which the filing office is designated in that section as the proper place to file.

(2) "Former-Article-9 records" means:

(A) financing statements and other records that have been filed in a local-filing office before the effective date of this Article, and that are, or upon processing and indexing will be, reflected in the index maintained, as of the effective date of this Article, by the local-filing office for financing statements and other records filed in the local-filing office before the effective date of this Article, and

(B) the index as of the day before the effective date of this Article. The term does not include records presented to a local-filing office for filing after the effective date of this Article, whether or not the records relate to financing statements filed in the local-filing office before the effective date of this Article.

(3) "Cooperative interest", "mortgage", "as-extracted collateral", "fixture filing", "goods" and "fixtures" have the meanings set forth in this Article.

(b) A local-filing office must not accept for filing a record presented on or after the effective date of this Article, whether or not the record relates to a financing statement filed in the local-filing office before the effective date of this Article.

(c) Until at least seven years after the effective date of this Article, each local-filing office shall maintain all former-Article-9 records in accordance with Former Article 9. A former-Article-9 record that is not reflected on the index maintained on the day before the effective date of this Article by the local-filing office must be processed and indexed as soon as practicable but in any event no later than thirty days after the effective date of this Article.

(d) Until at least seven years after the effective date of this Article, each local-filing office shall respond to requests for information with respect to former-Article-9 records relating to a debtor and issue certificates, in accordance with Former Article 9. The fees charged for responding to requests for information relating to a debtor and issuing certificates with respect to former-Article-9 records shall be the fees in effect under Former Article 9 on the day before the effective date of this Article, unless a different fee is later determined in accordance with section ninety-six-a of the executive law.

(e) Subsequent to seven years after the effective date of this Article, each local-filing office may remove and destroy, in accordance with any then applicable record retention law of this state, all former-Article-9 records, including the related index.

(f) This section shall not apply, with respect to financing statements and other records, to a filing office in which mortgages or records of mortgages on real property are required to be filed or recorded, if:

(1) the collateral is timber to be cut or as-extracted collateral; or

(2) the record is or relates to a financing statement filed as a fixture filing and the collateral is goods that are or are to become fixtures; or

(3) the collateral is a cooperative interest.

Appendix G. Example of Promissory Note

PROMISSORY NOTE
$5,000,000.00

For value received, JOE SCHMOE, an individual with a principal place of business at E.I. White Hall, Suite 144(i), Syracuse, New York 13244-1030 (the "Maker"), by this Promissory Note unconditionally promises to pay to BIG HEARTED BANK, a New York Corporation having its principal place of business at 1 Erie Street, Syracuse, New York 10030 (the "Holder") the principal sum of FIVE MILLION DOLLARS ($5,000,000.00) plus interest thereon, at a rate per annum equal to TWENTY FIVE PERCENT per cent (25%) per annum, all as further specified below.

Maker shall pay One Million annual installments of interest and principal of $25.00 per year, payable on the first day of each year, until all principal and interest have been paid in full.

If Maker fails to make payment of any part of principal or interest when due, at the sole option of Holder and without notice, the whole sum of principal and interest shall become immediately due and payable.

Maker hereby waives diligence, demand, protest, presentment, notice of dishonor or any other notice or demand whatsoever.

If the indebtedness evidenced by this Promissory Note is collected by or through an attorney, the Holder shall be entitled to recover reasonable attorney's fees to the extent permitted by applicable law.

This Promissory Note shall be governed by, and construed in accordance with, the laws of the State of New York, United States of America.

IN WITNESS WHEREOF, the Maker has duly executed this Promissory Note as of January 12, 2015.

_____

Joe Schmoe

Appendix H. Example of Security Agreement

SECURITY AGREEMENT

1. **Grant**. On this 12th day of January, 2012, JOE SCHMOE, with his principal place of business at EI White Hall, Suite 144(i), Syracuse, New York 13244-1030 (hereinafter called "Debtor"), for valuable consideration, receipt whereof is acknowledged, hereby grants to BIG HEARTED BANK, a New York corporation with its principal place of business at 1 Erie Street, Syracuse, New York 10030 (hereinafter called "Secured Party") a security interest in, and mortgages to Secured Party, the following described property and interests in property of Debtor (hereinafter called the "Collateral"):

   ALL INVENTORY AND EQUIPMENT, INCLUDING LAW BOOKS

   to secure payment of the following obligations of Debtor to Secured Party (all hereinafter called the "Obligations"):

   All obligations and liabilities of Debtor to Secured Party (including without limitation all debts, claims and indebtedness) whether primary, secondary, direct, contingent, fixed or otherwise, heretofore, now and/or from time to time hereafter owing, due or payable, however evidenced, created, incurred, acquired or owing and however arising, or by oral agreement or operation of law or otherwise.

2. **Warranties and Covenants of Debtor**. Debtor warrants and covenants that:
   2.1. Debtor is the owner of the Collateral free from any adverse lien, security interest or encumbrance; and Debtor will defend the Collateral against all claims and demands of all persons at any time claiming the same or any interest therein.
   2.2. No Financing Statement covering any of the Collateral or any proceeds thereof is on file in any public office. The Debtor shall immediately notify the Secured Party in writing of any change in name, address, identity or corporate structure from that shown in this Agreement and shall also upon demand furnish to the Secured Party such further information and shall execute and deliver to Secured Party such financing statements and other documents in form satisfactory to Secured Party and shall do all such acts and things as Secured Party may at any time or from time to time reasonably request or as may be necessary or appropriate to establish and maintain a perfected security interest in the Collateral as security for the Obligations, subject to no adverse liens or encumbrances; and Debtor will pay the cost of filing the same or filing or recording this agreement in all public offices wherever filing or recording is deemed by Secured Party to be necessary or desirable. A carbon, photographic or other reproduction of this agreement is sufficient as a financing statement.
   2.3. Debtor will not sell or offer to sell, assign, pledge, lease or otherwise transfer or encumber the Collateral or any interest therein, without the prior written consent of Secured Party.

2.4. Debtor shall keep the Collateral at all times insured against risks of loss or damage by fire (including so-called extended coverage), theft and such other casualties as Secured Party may reasonably require, including collision in the case of any motor vehicles, all in such amounts, under such forms of policies, upon such terms, for such periods and written by such companies or underwriters as Secured Party may approve, losses in all cases to be payable to Secured Party and Debtor as their interests may appear. All policies of insurance shall provide that Secured Party's interest therein shall not be invalidated by the act, omission or neglect of anyone other than Secured Party and for at least ten days' prior written notice of cancellation to Secured Party. Debtor shall furnish Secured Party with certificates of such insurance or other evidence satisfactory to Secured Party as to compliance with the provisions of this paragraph. Secured Party may act as attorney for Debtor in making, adjusting and settling claims under and cancelling such insurance and endorsing Debtor's name on any drafts drawn by insurers of the Collateral.

2.5. Debtor will keep the Collateral free from any adverse lien, security interest or encumbrance and in good order and repair, shall not waste or destroy the Collateral or any part thereof, and shall not use the Collateral in violation of any statute, ordinance or policy of insurance thereon.

2.6. Secured Party may examine and inspect the Collateral at any reasonable time or times, wherever located.

2.7. Debtor will pay promptly when due all taxes and assessments upon the Collateral or for its use or operation or upon this Agreement or upon any note or notes evidencing the Obligations.

3. **Additional Rights of Parties**. At its option, Secured Party may discharge taxes, liens or security interests or other encumbrances at any time levied or placed on the Collateral, may place and pay for insurance on the Collateral upon failure by the Debtor, after having been requested to do so, to provide insurance satisfactory to the Secured Party, and may pay for the maintenance, repair, and preservation of the Collateral. To the extent permitted by applicable law, Debtor agrees to reimburse Secured Party on demand for any payment made, or any expense incurred by Secured Party pursuant to the foregoing authorization. Until default Debtor may have possession of the Collateral and use it in any lawful manner not inconsistent with this agreement and not inconsistent with any policy of insurance thereon.

4. **Events of Default**. Debtor shall be in default under this agreement upon the occurrence of any of the following events or conditions, namely: (a) default in the payment or performance of any of the Obligations or of any covenants or liabilities contained or referred to herein or in any of the Obligations; (b) any warranty, representation or statement made or furnished to Secured Party by or on behalf of Debtor proving to have been false in any material respect when made or furnished; (c) loss, theft, substantial damage, destruction, sale or encumbrance to or any of the Collateral, or the making of any levy, seizure or attachment thereof or thereon; (d) dissolution, termination of existence, filing by Debtor or by any third party against Debtor of any petition under any Federal bankruptcy statute, insolvency, business failure, appointment of a receiver of any part of the property of, or assignment for the benefit of creditors by, Debtor;

or (e) the occurrence of an event of default in any agreement between Debtor and/or Secured Party.

5. **Remedies**. UPON DEFAULT AND AT ANY TIME THEREAFTER, SECURED PARTY MAY DECLARE ALL OBLIGATIONS SECURED HEREBY IMMEDIATELY DUE AND PAYABLE AND SHALL HAVE THE REMEDIES OF A SECURED PARTY UNDER THE UNIFORM COMMERCIAL CODE OF NEW YORK, including without limitation the right to take immediate and exclusive possession of the Collateral, or any part thereof, and for that purpose may, so far as Debtor can give authority therefor, with or without judicial process, enter (if this can be done without breach of the peace), upon any premises on which the Collateral or any part thereof may be situated and remove the same therefrom (provided that if the Collateral is affixed to real estate, such removal shall be subject to the conditions stated in the Uniform Commercial Code of New York); and the Secured Party shall be entitled to hold, maintain, preserve and prepare the Collateral for sale, until disposed of, or may propose to retain the Collateral subject to Debtor's right of redemption in satisfaction of the Debtor's Obligations as provided in the Uniform Commercial Code of New York. Secured Party without removal may render the Collateral unusable and dispose of the Collateral on the Debtor's premises. Secured Party may require Debtor to assemble the Collateral and make it available to Secured Party for possession at a place to be designated by Secured Party which is reasonably convenient to both parties. Unless the Collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Secured Party will give Debtor at least 5 days' notice of the time and place of any public sale thereof or of the time after which any private sale or any other intended disposition thereof is to be made. The requirements of reasonable notice shall be met if such notice is mailed, postage prepaid, to the address of Debtor shown at the beginning of this agreement at least ten days before the time of the sale or disposition. Secured Party may buy at any public sale. The net proceeds realized upon any such disposition, after deduction for the expenses of retaking, holding, preparing for sale or lease, selling, leasing and the like and the reasonable attorney's fees and legal expenses incurred by Secured Party, shall be applied in satisfaction of the Obligations secured hereby. The Secured Party will account to the Debtor for any surplus realized on such disposition and the Debtor shall remain liable for any deficiency.

   The remedies of the Secured Party hereunder are cumulative and the exercise of any one or more of the remedies provided for herein or under the Uniform Commercial Code of New York shall not be construed as a waiver of any of the other remedies of the Secured Party so long as any part of the Debtor's Obligation remains unsatisfied.

6. **General**. No waiver by Secured Party of any default shall operate as a waiver of any other default or of the same default on a future occasion. All rights of Secured Party hereunder shall inure to the benefit of its successors and assigns; and all obligations of Debtor shall bind its successors or assigns. If there be more than one Debtor, their obligations hereunder shall be joint and several. This agreement shall become effective when it is signed by Debtor.

All rights of the Secured Party in, to and under this agreement and in and to the Collateral shall pass to and may be exercised by any assignee thereof. The Debtor agrees that if the Secured Party gives notice to the Debtor of an assignment of said rights, upon such notice the liability of the Debtor to the assignee shall be immediate and absolute. The Debtor will not set up any claim against the Secured Party as a defense, counterclaim or set-off to any action brought by any such assignee for the unpaid balance owed hereunder or for the possession of the Collateral, provided that Debtor shall not waive hereby any right of action to the extent that waiver thereof is expressly made unenforceable under applicable law.

If any provision of this agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this agreement.

SECURED PARTY:	**DEBTOR:**
BIG HEARTED BANK,	_____
A New York Corporation	JOE SCHMOE
By_____	
Joe Heart	
Its President and Chief Executive	
Officer	

Appendix I. UCC Financing Statement

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (1a or 1b) - do not abbreviate or combine names

1a. ORGANIZATION'S NAME				
OR 1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
1c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
1d. SEE INSTRUCTIONS / ADD'L INFO RE ORGANIZATION DEBTOR / 1e. TYPE OF ORGANIZATION	1f. JURISDICTION OF ORGANIZATION	1g. ORGANIZATIONAL ID #, if any		☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME - insert only one debtor name (2a or 2b) - do not abbreviate or combine names

2a. ORGANIZATION'S NAME				
OR 2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
2c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
2d. SEE INSTRUCTIONS / ADD'L INFO RE ORGANIZATION DEBTOR / 2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATIONAL ID #, if any		☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) - insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME				
OR 3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
3c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

FILING OFFICE COPY — UCC FINANCING STATEMENT (FORM UCC1) (REV. 05/22/02)

As of 11/5/2021