AMERICAN BANKRUPTCY INSTITUTE

2017 Midwestern Bankruptcy Institute

Bankruptcy Law Round-Up

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CHALLENGES IN APPOINTING CHAPTER 11 CREDITORS' COMMITTEES

PRESENTED BY
ACTING U.S. TRUSTEE DANIEL J. CASAMATTA
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THE CODE

- § 1102(a)(1): "…as soon as practicable" UST "shall appoint" committee of unsecured creditors and "may appoint" additional committees that the UST deems appropriate
- § 1102(b)(1): committee "shall ordinarily consist" of holders of seven largest claims who are willing to serve

2

SOLICITATION BEST PRACTICES

- Move swiftly
- Gather relevant information
  - Debtor's industry and financial history
  - Creditor composition
  - Debtor's debt structure
  - 20 largest unsecured creditors and maybe more
- Contact eligible creditors
- Creditors should be aware that receiving a solicitation does not guarantee selection

3

LOGISTICS OF SOLICITATION

- UST will either conduct a formation meeting or make phone calls to creditors
- UST will prepare and send solicitation packages
  - Sets timelines and return deadlines
  - Formation information may be available on UST website

4

LOGISTICS OF FORMATION MEETING

- Location
- Public portions of meeting
  - Debtor presentation and case overview
- Private portions of meeting
  - Individual consultations

5

CREDITOR INTERVIEWS

Phone or Meeting:

- Individual consultations
- Gather information
- Completed questionnaire is *starting* point for further inquiry

6

STATUTORY ELIGIBILITY

Eligible:

- Disputed claims
- Contingent claims
- Unliquidated claims
- Indenture trustee
- Labor representative

7

GOVERNMENTAL CREDITOR ELIGIBILITY

Generally eligible:

- PBGC
- FDIC
- Acquirer of loan under guarantee

Not eligible:

- Those outside exceptions of § 101(41)(A)

8

STATUTORILY ELIGIBLE BUT. . .?

- Any status or position that may affect ability to fulfill fiduciary duty to entire unsecured creditor body?
- Some may be *per se* disqualifying
- Others may need evaluation on individual basis

9

PER SE DISQUALIFYING

- To be paid in full before other unsecureds:
  - Full administrative or reclamation / section 503(b)(9) claimant
  - Critical vendor
  - Executory contract assumed and defaults to be cured
- Pre-petition plan support agreements ("PSAs," "RSAs," "lock-ups") that absolutely and unconditionally restrict creditor actions

10

NOT PER SE DISQUALIFYING

- Undersecured creditor
- Equity holder
- Potential purchaser
- Competitor
- Claims traders (trading order)
- Inter-creditor agreement
- Credit insurance or other hedge
- Former counsel to debtor
- Insider

11

COMMITTEE COMPOSITION

- Balanced with kinds of claims held by creditors willing to serve
- Need not be proportional, just broadly representative
- Need not be largest claims
- No members with status or conflict that fatally impairs fiduciary duty
- No right to committee membership
- Not a platform for a particular creditor

12

JOINTLY ADMINISTERED CASES

- Debtor should provide 20 largest creditors in each case, *i.e.*, file list on a "non-consolidated" basis
- One committee may be acceptable

13

PROXIES

- Rule 9010 specifically permits proxies
  - AOUSC Director Forms 4011 A and B
- No per se prohibition on a proxy holder appearing at a formation meeting
- But creditor, not representative, should be appointed to committee
- UST may inquire about proxy status
- *In re Universal Bldg. Products*, 486 B.R. 650 (Bankr. D. Del. 2010)

14

RULE 2019

- Rule imposes mandatory disclosures by official (and unofficial) committees
- Official committee disclosures must be verified and include:
  - Name and address
  - "Disclosable Economic Interest"
- Disclosures must be supplemented if information changes
- *See* UST Manual on website, section 3-4.7.2 for additional information

15

USTP PRACTICES AND PROFESSIONAL RETENTION

- USTP not involved in the committee's selection process of professionals other than to ensure no manipulation
- USTP will not:
  - Accept or distribute promotional materials of professionals
  - Arrange "beauty contests"
  - Recommend or suggest particular professionals
  - Use law firm resources (like conference lines or rooms) for official formation calls or meetings

16

POLICING COMMITTEE PROFESSIONAL RETENTION

- Problem: professionals who try to manipulate the committee selection process in order to ensure that they will be hired
- Lessons of Universal Building: Proxy abuse and non-disclosure in retention applications led to denial of counsel's retention

17

ADDITIONAL COMMITTEES, MODIFICATION, AND AD HOC COMMITTEES

18

ADDITIONAL COMMITTEES: TWO PATHS

- § 1102(a)(1) – UST has discretion to appoint as "deems appropriate"
- § 1102(a)(2) – Court may order UST to appoint on motion showing necessary for "adequate representation"

19

MOTION TO APPOINT ADDITIONAL COMMITTEE

- Filed by party seeking court order directing appointment under 1102(a)(2)
- Standard is "necessary to assure adequate representation"
  - Not a challenge to or review of UST's decision not to appoint under 1102(a)(1)
  - Standard is not whether UST abused discretion in not forming under 1102(a)(1)

20

COMMITTEE MODIFICATION: TWO PATHS

- UST may independently decide to remove or to add members
- Party may move court to order the UST to modify membership – Section 1102(a)(4)
  - Standard is "necessary for adequate representation"
    - Not a review of the UST's formation decision
  - If movant satisfies burden, court makes findings about adequate representation
  - UST then reconstitutes to satisfy the court's findings

21

CASE DECISIONS

- ***In re ShoreBank Corp.*, 467 B.R. 156 (Bankr. N.D. Ill. 2012)**
  - Court applied correct legal standards for committee modification and denied modification motion
- ***In re Caesars Entertainment Operating Co.*, 526 B.R. 265 (Bankr. N.D. Ill. 2015)**
  - Debtors moved to disband additional committee appointed by UST under section 1102(a)(1)
  - UST objected, arguing that the Code did not authorize the relief
  - Court denied debtors' motion to disband committee appointed by UST under section 1102(a)(1), citing a lack of statutory authority to do so

22

CASE DECISIONS CONT'D

- ***In re Commonwealth of Puerto Rico*, No. 17-03283, *slip op.* (D.P.R. Aug. 11, 2017)**
  - Bondholders claiming they were secured first priority creditors moved to reconstitute unsecured creditors' committee to include them because the debtors claimed they were unsecured creditors
  - UST objected, arguing movants failed to meet their burden and their assertion that they were wholly secured rendered them unentitled to official representation and unsuited for service
  - Court denied motion to reconstitute committee based on movants' failure to show lack of adequate representation and on their ineligibility to serve

23

AD HOC COMMITTEES

- Not appointed by UST
- Limited fiduciary duties
- Limited statutory duties/powers
- No statutory right to fees

24

COMPENSATION OF AD HOC COMMITTEES

- Not estate professionals and no section 330 compensation
- 503(b) compensation possible only if ad hoc committee has made substantial contribution
- Not proper for ad hoc groups to circumvent 503(b) through plan provisions or settlements

25

APPOINTING AD HOC COMMITTEES AS OFFICIAL COMMITTEES

- Section 1102(b)(1)/ Rule 2007: Ad hoc committee formed prepetition may be appointed by UST as official committee
- Sometimes appropriate in prepackaged cases
- May also be appointed as additional committee under either (a)(1) or (a)(2)

26

RULE 2019

- Applies to ad hoc committees and others "acting in concert"
- Special disclosure requirements
- Membership
- Timing/ nature/ amount of economic interest of each member
- Facts regarding formation
- If purporting to act on behalf of others, must submit copy of instrument
- If no compliance, court may deny standing to be heard

27

Midland Funding LLC v. Johnson, 137 S. Ct. 1407 (2017)

Filing of an obviously time-barred claim in a Chapter 13 case is not false, deceptive, misleading, unfair, or unconscionable debt collection practice within the meaning of the Fair Debt Collection Practices Act

Facts: Debt collector Midland Funding filed a proof of claim in Aleida Johnson's Chapter 13 case. It was clear on the face of the claim that it was based on a credit card debt that was incurred more than 10 years before Johnson filed for bankruptcy. Johnson objected to the claim, asserting the applicable six-year statute of limitations. Midland did not respond. The bankruptcy court in the Southern District of Alabama disallowed the claim.

Johnson then initiated a lawsuit in district court against Midland for violation of the FDCPA, seeking actual damages, statutory damages, and attorney's fees and costs. The FDCPA prohibits a debt collector from asserting any "false, deceptive, or misleading representation," or using any "unfair or unconscionable means" to collect, or attempt to collect, a debt. 15 U.S.C. §§1692e, 1692f. The district court dismissed the action, holding that a creditor's right to file a time-barred claim under the Code precluded the debtors from challenging that practice as a violation of the FDCPA. The 11th Circuit reversed, holding that the FDCPA was not precluded by the Bankruptcy Code and that the two statutes could be construed to coexist. The Supreme Court granted certiorari to resolve a circuit split on the issue.

Holding: Reversed. The filing of a proof of claim that is obviously time-barred does not fall within the scope of the FDCPA in that it is not "false," "deceptive," "misleading," "unconscionable" or "unfair." (Justices Breyer, Roberts, Kennedy and Alito)

Analysis: With respect to the words "false," "deceptive," or "misleading," **t**he Supreme Court began with the Bankruptcy Code's definition of "claim" as a "right to payment" under §101(5)(A), and noted that the word "enforceable" does not appear in that definition.

The Court also relied on the relevant Alabama law providing that a creditor has the right to the payment of a debt even after the limitations period has expired. (The passage of time extinguishes the remedy but the right remains.)

The Supreme Court rejected Johnson's argument that other provisions (*e.g.,* §502(a) and Rule 3001(f)) support the interpretation of "claim" as "*enforceable* claim." The Court observed that Congress' intent was to adopt the broadest available definition of "claim," and that the Code makes clear that limitations constitutes an affirmative defense that a debtor can assert after a creditor makes a claim.

The Court also noted that the determination of whether a statement is misleading normally requires consideration of the legal sophistication of its audience. In a Chapter 13 case, the audience includes a trustee who is likely to understand that a proof of claim is subject to disallowance based on several grounds, including untimeliness.

With respect to the words "unfair" or "unconscionable," Johnson argued that, in the context of an ordinary civil action, several lower courts had found that a debt collector's assertion of a claim known to be time-barred was "unfair." The Supreme Court distinguished those cases on the basis that the lower courts were concerned that a consumer might unwittingly repay a time-barred debt. Those concerns are diminished in a bankruptcy context where the consumer initiates the proceeding, where procedural rules guide the evaluation of claims, and where the claims resolution process is generally more streamlined and less unnerving for the debtor.

The Court also found unpersuasive Johnson's argument that the practice of filing time-barred claims risks harm to the debtor. It observed that the bankruptcy system treats untimeliness as an affirmative defense and the assertion of that defense can even benefit the debtor on occasion.

The Supreme Court also pointed out that the FDCPA and the Bankruptcy Code have different purposes and structural features: the Act seeks to help consumers by preventing consumer bankruptcies,

while the Code creates and maintains the "delicate balance of a debtor's protections and obligations." Carving out an exception for a limitations affirmative defense would upset that balance, add complexity to the claims process, and shift the obligation to investigate the staleness of a claim from the debtor to the creditor.

Finally, the Court dismissed the argument that Bankruptcy Rule 9011 settled the issue, finding it noteworthy that the Advisory Committee specifically rejected a proposal that would have required a creditor to certify that there was no valid limitations defense. The Court also noted that only one bankruptcy court has held that sanctions were warranted under Rule 9011 for filing a time-barred claim without a pre-filing investigation, but that many courts have held to the contrary.

Dissent (Justices Sotomayor, Ginsburg and Kagan)**:** The dissent is primarily policy-oriented, focusing on the sheer size of the debt-buying industry and its widespread practice of filing objectionable claims in the hopes that the bankruptcy system will fail. The dissent also cited the similarities between civil lawsuits and the bankruptcy process, stating that there was no sound reason to depart from the civil courts' conclusion that the practice of collecting debts that are knowingly time-barred violates the FDCPA.

Additionally, the dissent disagreed with the majority's reliance on the presence of a bankruptcy trustee and the bankruptcy system to weed out meritless claims. Citing the government which oversees trustees and the trustees themselves, the dissent contends trustees are struggling under a deluge of stale debt and cannot realistically be expected to identify every time-barred claim filed in every case.

The dissent concluded with these words:

"It does not take a sophisticated attorney to understand why the practice I have described in this opinion is unfair. It takes only [sic] common sense to conclude that one should not be able to profit on the inadvertent inattention of others. It is said that the law should not be a trap for the unwary. Today's decision sets just such a trap."

Aftermath: While the case resolved one question, others remain.

First, does preclusion apply to bar an FDCPA action in bankruptcy? Given that the determination was made that the FDCPA was not violated, it seems unlikely. Second, does the holding extend to Chapter 7 cases? Lastly, what, if any, effect will the holding have on the U.S. Trustee's position on filing claims for out-of-statute debt?

Only a few cases have cited *Midland Funding* for its holding on the filing of time-barred claims. *See Casamatta v. Resurgent Capital Services, L.P., et al.*, 2017 WL 3841739 (Bankr. W.D. Mo. Sept. 1, 2017)(holding that the filing of time-barred claims is not sanctionable conduct); (*Kaiser v. Cascade Capital LLC,* 2017 WL 2332856 (D. Or. May 25, 2017)(limiting *Midland Funding's* holding to bankruptcy cases, and concluding that it did not alter the persuasive weight of the civil cases discussed in the opinion).

2017 Midwestern Bankruptcy Institute

Estoppel Doctrines (Equitable, Judicial & Collateral) & Equitable Mootness

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1. Equitable Estoppel—"Duping" or "Tricking"

A. Definition

Equitable estoppel is an equitable doctrine used to avoid injustice. The normal elements of equitable estoppel dictate that a claim or defense is precluded against a party who detrimentally relied on the conduct of the party who asserted the claim or defense.

Equitable estoppel is used to estop a party from denying facts that it has previously asserted to be true if the party to whom the representation was made has acted in reliance on the representation and will be prejudiced by its repudiation. Courts apply equitable estoppel when intentional self-contradiction is being used as a means of obtaining an unfair advantage over another. *Total Petroleum, Inc. v. Davis*, 822 F.2d 734, 737 (8th Cir. 1987).

Courts often confuse equitable estoppel and judicial estoppel, but each doctrine has different elements and goals. Unlike judicial estoppel, equitable estoppel requires a party to establish "privity" and "detrimental reliance," and its primary policy goal is to "ensure[] fairness in the relationship between parties." *Olson v. Ford Motor Co.*, 411 F.Supp.2d 1137, 1141 (D.N.D. 2006).

B. Elements

To constitute an equitable estoppel:

1. There must exist a false representation or concealment of material facts;
2. It must have been made with knowledge, actual or constructive, of the facts;
3. The party to whom it was made must have been without knowledge or the means of knowledge of the real facts;
4. It must have been made with the intention that it should be acted upon; and
5. The party to whom it was made must have relied on or acted upon it to his prejudice.

Willis v. Rice (*In re Willis*), 345 B.R. 647, 651–52 (B.A.P. 8th Cir. 2006) (quoting *Rath Packing Co. v. Paul Blood Farms, Inc.,* 419 F.32d 13, 17 (8th Cir. 1969)).

C. Special Issues

1. *Silence as Affirmative Conduct*:
   a. A party's silence may amount to a false representation for purposes of equitable estoppel only when the party had an obligation to speak. *In re Neagle*, 2012 WL 560299 at *2 (Bankr. D.C. Feb. 21, 2012) (citing *Wiser v. Lawler*, 23 S.Ct. 624, 628 (1903) ("To constitute an estoppel by silence

there must be something more than an opportunity to speak. There must be an obligation.").

b. The representation may be manifested by affirmative conduct in the form of acts or words, or by silence amounting to concealment of material facts. To amount to concealment, these material facts must be known to the party estopped and unknown to the other party. *Roy v. MBW Constr., Inc.*, 477 S.W.3d 678, 686 (Mo. Ct. App. 2015) (quoting *Comens v. SSM St. Charles Clinic Med. Group, Inc.*, 258 S.W.3d 491, 497 (Mo. Ct. App. 2008)).

c. The silence must be deceptive in the sense that "[t]he party maintaining silence must have known that someone was relying thereon, and was either acting, or about to act, as he would not have done had the truth been told." *In re Neagle*, 2012 WL 560299, at *2 (Bankr. D.C. Feb. 21, 2012) (quoting *Willis v. Rice* (*In re Willis*), 345 B.R. 647, 652 (B.A.P. 8th Cir. 2006)).

2. *Equitable Estoppel Asserted Against the Government*:
   a. Burden of establishing equitable estoppel against the government is especially high.
   b. Party must show affirmative misconduct or actual fraud—an affirmative act or misrepresentation or concealment. Negligence, delay, inaction, or failure to follow agency guidelines does not suffice to establish affirmative misconduct.
   c. Party still must have detrimentally relied on the government's conduct.
   d. Judge Russell says in his *Bankruptcy Evidence Manual*: "Although the Supreme Court has never held that the government cannot be estopped, the Court has overruled every finding of estoppel against the government thus far." *Bankr. Evid. Manual* § 5.4 (2014 ed.) (citing *Ingalls Shipbuilding, Inc. v. Director, Office of Workers' Compensation Programs, U.S. Dept. of Labor*, 976 F.2d 934, 937 (5th Cir. 1992).

3. *Federal Law Standard in 8th Circuit*: To prevail under a theory of equitable estoppel under federal law, "the party requesting estoppel must show that the defendants have engaged in 'affirmative conduct . . . that was designed to mislead or was unmistakably likely to mislead' a plaintiff." *In re Wertz*, 557 B.R. 695, 705 (Bankr. E.D. Ark. 2016) (quoting *Bell v. Fowler* 99 F.3d 262, 268-69 (8th Cir. 1996).

4. *Evidentiary Standard*: A party must establish each element of equitable estoppel with "clear and satisfactory evidence." *See Back Ventures, LLC v. Safeway, Inc.*, 410 S.W.3d 245, 255 n. 10 (Mo. Ct. App. 2013).

5. *Factors Precluding the Application of Equitable Estoppel:*
   a. Both parties have equal knowledge of, or equal means of obtaining, the truth.
   b. A party who makes an honest mistake of law or fact may not be intentionally misleading the other party.

c. A party's silence ordinarily will not give rise to equitable estoppel unless that party has a duty to disclose.

D. Demonstrative Cases

1. *In re Barry Richard Wertz, II*, 557 B.R. 695 (Bankr. E.D. Ark. 2016). Chapter 13 Debtor was not equitably estopped from currently assigning a different value to his vehicle than the value he assigned in a prior Chapter 13 case that was dismissed before completion. Debtor lacked the requisite intent to mislead creditors. No evidence indicated Debtor had engaged in affirmative conduct to mislead, lull, or trick the creditor, nor that Debtor knew facts of which the creditor was ignorant.

2. *Willis v. Rice* (*In re Willis*), 345 B.R. 647 (B.A.P. 8th Cir. 2006). Chapter 7 Debtor was estopped from using her failure to sign her bankruptcy petition as a basis for dismissing the case or converting the case to Chapter 11. She waited several weeks to advise the court and parties that she had never signed the petition, during which time she enjoyed the benefits of bankruptcy and objected to multiple motions for relief from the automatic stay.

3. *In re Smith*, 379 B.R. 315 (Bankr. N.D. Ill. 2007). Chapter 7 Debtor/physician was equitably estopped from raising a Rule 4007 bar date for former patients to file dischargeability complaints because Debtor was aware of the patients' state court lawsuits but did not list the patients in his schedules and patients did not have actual knowledge of the bankruptcy case.

4. *In re Shethi*, 389 B.R. 588 (Bankr. N.D. Ill. 2008). Debtors were not equitably estopped from amending their exemption schedule to exclude their interest in insurance policies under a more generous provision than the one they originally claimed. Trustee's claim of detriment was ineffective. In addition, Trustee could not show the reasonableness of his reliance on Debtors' schedules filed before Trustee made an investigation into Debtors' insurance interests. The court also noted that "[a]pplication of the doctrine in this case would be inequitable – particularly in light of the fact that the trustee's reasonable fees and expenses appear to be more than amply covered by the cash surrender value to the estate."

5. *Miller v. U.S.*, 907 F.2d 80 (8th Cir. 1990). Even if equitable estoppel applies against the United States, the terms are not the same. "[A] party must at least show 'affirmative misconduct' by the government in addition to establishing the traditional elements of estoppel." The government was not estopped from contesting Debtor's eligibility for Chapter 13 relief when it participated in the development of Debtor's Chapter 13 plan and then objected to Debtor's eligibility.

6. *In re Gunsmith's Inc.*, 271 B.R. 487 (S.D. Miss. 2000). Former Chapter 11 Debtors' failure to list lender liability claims in their bankruptcy schedules, plan, or disclosure statement equitably and judicially estopped them from pursuing claims outside of bankruptcy after the case was converted to Chapter 7 and closed with no distribution.

7. *In re Neagle*, No. 11-00025, 2012 WL 560299 (Bankr. D.C. Feb. 21, 2012). Equitable estoppel did not bar a creditor from asserting priority of its lien, although the creditor waited more than three months before recording its deed of trust. The creditor's failure to timely record did not create a false representation by silence because it had no obligation to disclose the existence of its deed of trust under the facts of the case. In addition, there was no reasonable reliance by a creditor who filed a later deed of trust.

8. *In re Zenga*, 562 B.R. 341 (B.A.P. 6th Cir. 2017). Equitable estoppel did not preclude Debtors in an involuntary Chapter 7 case from introducing evidence that they had more than 11 creditors. Debtors factually misrepresented the number of creditors they had by only listing ten creditors on an interrogatory when they had more than ten. The petitioning creditor relied on that representation and did not join any other creditors to his involuntary petition against Debtors as required under 11 U.S.C. § 303(b). When the petitioning creditor argued equitable estoppel prevented Debtors from modifying the number of creditors they had, he was unable to show, besides loss of time, that he suffered actual and substantial detriment due to his reliance on Debtors' factual misrepresentation. Thus, equitable estoppel did not apply to prevent the debtors from introducing evidence of the existence of more than 11 creditors.

2. Judicial Estoppel—"Flip-Flop"

A. Definition

Under judicial estoppel, a party who asserts and successfully maintains a position in a legal proceeding may not simply because its interests have changed later assume a contrary position in a way that prejudices a second party who acquiesced to the initial position. *See New Hampshire v. Maine*, 532 U.S. 742, 749 (2001).

"The principle is that if you prevail in Suit #1 by representing that A is true, you are stuck with A in all later litigation growing out of the same events." *Forty-Eight Insulations, Inc. v. Aetna Cas. & Sur. Co.*, 162 B.R. 143, 147 (N.D. Ill. 1993).

B. Purpose

1. Judicial estoppel protects the integrity of the judicial process so parties cannot deliberately take inconsistent positions in court "according to the exigencies of the moment." *New Hampshire v. Maine*, 532 U.S. 742, 743 (2001); *In re Wertz*, 557 B.R. 695, 707 (Bankr. E.D. Ark. 2016) (quoting *New Hampshire v. Maine*, 532 U.S. 742, 749–50 (2001).

2. Judicial estoppel gives judges discretion to protect parties from unfair prejudice. *See New Hampshire v. Maine*, 532 U.S. 742, 751 (2001).

3. Judicial estoppel prevents the parties from playing "fast and loose" with the courts

C. Special Issues

1. *Procedural Issues*:
   a. Federal Law governs the application of judicial estoppel in bankruptcy proceedings. *In* re *Wertz*, 557 B.R. 695, 706 (Bankr. E.D. Ark. 2016).

b. *Anderson v. Seven Falls Co.,* No. 16-1377, 2017 WL 2533356 (10th Cir. June 12, 2017). Chapter 7 Debtor was judicially estopped from recovering the full value of a personal injury claim because she failed to list the anticipated claim on her bankruptcy schedules. Months after Debtor obtained a Chapter 7 discharge, she filed her personal injury claim and concurrently amended her bankruptcy schedules to reflect the claim. After substituting the Trustee as the true party in interest, the District Court limited the potential damages recoverable in the personal injury case to the amounts Debtor owed creditors at the time of recovery, plus attorneys' fees and Trustee's fee, reasoning that Debtor was estopped from benefitting from her omission, but Trustee and creditors were not. The Tenth Circuit affirmed, finding that Debtor's post hoc amendment to her bankruptcy schedules failed to cure her omission.

2. *Application:*
   a. Courts apply judicial estoppel narrowly and cautiously. *Blair v. Alcatel-Lucent Long Term Disability Plan*, No. 16-7062, 2017 WL 1906615, at *8 (10th Cir. May 9, 2017) (citing *Asarco, LLC v. Noranda Mining, Inc.*, 844 F.3d 1201, 1207–08 (10th Cir. 2017)).
   b. The following factors affect whether a judge will apply or decline to apply the doctrine in his or her discretion:
      i. Whether a party's later position is "clearly inconsistent" with the former position.
      ii. Whether the party to be estopped has succeeded in persuading the first court to accept that party's earlier position, so that judicial acceptance of an inconsistent position in a later proceeding would create the perception that either the first or the second court was misled (e.g., failure to disclose an asset and the case is closed without Trustee administration of the undisclosed property).
         (a) Note: The Sixth Circuit expressly requires that a court make a preliminary or final decision in reliance on the party's earlier contrary assertion. *In re Zenga*, 562 B.R. 341, 349 (B.A.P. 6th Cir. 2017) (quoting White v. Wyndham Vacation Ownership, Inc., 617 F.3d 472, 476 (6th Cir. 2010)).
      iii. Whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped (e.g., the debtor prosecutes a lawsuit after failing to disclose the lawsuit in her bankruptcy case). *New Hampshire v. Maine*, 532 U.S. 742, 749 (2001).

c. Non-disclosure of a claim must be advertent to merit judicial estoppel. *Stallings v. Hussmann Corp.*, 447 F.3d 1041 (8th Cir. 2006).

D. Demonstrative Cases

1. *Opportunity Finance, LLC v. Kelly*, 822 F.3d 451 (8th Cir. 2016). Chapter 11 Trustee was not estopped from asserting Debtors' lenders lacked standing to appeal a bankruptcy court's substantive consolidation order. In Trustee's motion to certify the appeals directly to the Eighth Circuit, Trustee asserted that the district court had jurisdiction over the ending appeals. Trustee's statement was not clearly inconsistent with the later position that the lenders lacked standing to appeal. The district court did not accept an inconsistent position when it agreed that it had jurisdiction over the matter, and lenders did not show that they suffered an unfair detriment or that Trustee gained an unfair advantage.

2. *Van Horn v. Martin*, 812 F.3d 1180 (8th Cir. 2016). Chapter 13 Debtor was judicially estopped from pursuing employment discrimination and equal protection claims in federal district court because she did not amend her bankruptcy schedules to disclose the claims. Debtor was aware of the claims while her bankruptcy case was pending and she obtained a Chapter 13 discharge.

3. *Jones v. Bob Evans Farms, Inc.*, 811 F.3d 1030 (8th Cir. 2016). Judicial estoppel bared Chapter 13 Debtor from pursuing employment discrimination action in state court (which was removed to federal court) during the course of his bankruptcy case. Debtor did not disclose the action to the case trustee and Debtor received a bankruptcy discharge. Debtor's motion to reopen his bankruptcy case and amendment of his schedules to disclose the action after the district court ruled against him on the judicial estoppel issue did not show inadvertence by him. Debtor knew, based on other activity in the case, that he had to disclose pending legal claims.

4. *ASARCO, LLC v. Noranda Mining, Inc.*, No. 16-4045, 2017 WL 24609 (10th Cir. Jan. 3, 2017). ASARCO, LLC was not judicially estopped from pursing its claim in a contribution action against Noranda Mining, Inc. in an action filed under the Comprehensive Environmental Response, Compensation, and Liability Act based on representations it made in the bankruptcy court concerning its settlement with the Environmental Protection Agency.

5. *In re Christakos*, 553 B.R. 371 (Bankr. W.D. Mo. 2016). Chapter 7 Debtor was not judicially estopped from arguing that post-petition child support was excluded from property of her Chapter 7 estate where Debtor listed the right to child support as an asset of the estate and claimed it as exempt, despite Chapter 7 Trustee's objection to Debtor's claimed exemption. Debtor was required to list the child support as an asset on her schedules and it was prudent, therefore, to claim an exemption in it, no one was misled, and Trustee did not allege that Debtor would obtain an unfair advantage or had imposed an unfair detriment.

6. *Marshall v. Honeywell Tech. Sys. Inc.*, 828 F.3d 923, 928 (D.C. Cir. 2016), *cert. denied*, 137 S. Ct. 830, 197 L. Ed. 2d 69 (2017). Recently, most appellate courts have applied abuse of discretion standard when reviewing judicial estoppel decisions.[1]

7. *In re Gregory*, No. 10-50237, 2017 WL 2589332 (Bankr. W.D. Mo. June 14, 2017). Debtor who signed a statement of intention to surrender realty under 11 U.S.C. §521(a)(2) was not judicially estopped from later claiming ownership of the realty in a state court trespass action. The statement of intention was not a promise or position, but merely indicated Debtor's intent as to the property at the time of signing. Debtor did not need to act in conformity with his stated intention to achieve a discharge.

[1] *See also Guay v. Burack*, 677 F.3d 10, 15–16 (1st Cir. 2012); *McNemar v. Disney Store, Inc*., 91 F.3d 610, 613 (3d Cir. 1996); *King v. Herbert J. Thomas Mem'l Hosp*., 159 F.3d 192, 196, 198 (4th Cir. 1998); *Jethroe v. Omnova Sols., Inc.*, 412 F.3d 598, 599–600 (5th Cir. 2005); *EEOC v. CRST Van Expedited, Inc.*, 679 F.3d 657, 678 (8th Cir. 2012); *Engquist v. Or. Dept. of Agric.*, 478 F.3d 985, 1000 (9th Cir. 2007); *Eastman v. Union Pac. R.R. Co.*, 493 F.3d 1151, 1155–56 (10th Cir. 2007); *Talavera v. Sch. Bd. of Palm Beach Cty.*, 129 F.3d 1214, 1216 (11th Cir. 1997); *Data Gen. Corp. v. Johnson,* 78 F.3d 1556, 1565 (Fed. Cir. 1996); *but see Browning v. Levy*, 283 F.3d 761, 775 (6th Cir. 2002) (reviewing application of judicial estoppel de novo); *U.S v. Hook*, 195 F.3d 299, 305 (7th Cir. 1999) (same); *Intellivision v. Microsoft Corp*., 484 F. App'x 616, 618 (2d Cir. 2012) ("because the district court's decision must be affirmed even on de novo review, we need not decide this 'open question' regarding the proper standard of review.").

8. *Combs v. The Cordish Companies, Inc.*, 862 F.3d 671 (8th Cir. 2017). Chapter 7 Debtor who failed to disclose an impending race discrimination action in his schedules was not judicially estopped from recovering in a subsequent § 1981 action where the discriminatory incidents occurred after he filed in Chapter 7 but during the pendency of his bankruptcy proceedings. Because Chapter 7 bankruptcy estates only include property debtors hold at filing, Chapter 7 debtors need not amend their filings to reflect causes of action that accrue after filing, and are only estopped from bringing undisclosed claims that existed at the time of filing. In contrast, Chapter 13 debtors must amend their schedules to reflect causes of action that accrue after filing because Chapter 13 estates include property and wages debtors accumulate while their cases are pending. *See also*, *Byrd v. Wellpoint Flexible Benefit Plan*, No. 4:17 CV 0008 JMB, 2017 WL 1633204 (E.D. Mo. May 2, 2017). *C.f. Jones v. Bob Farms, Inc.*, 811 F.3d 1030 (8th Cir. 2016) (reaching the opposite conclusion in a chapter 13 case); *Van Horn v. Martin*, 812 F.3d 1180 (8th Cir. 2016) (same).

9. *Meyer v. Nw. Tr. Servs.*, No. 15-35560, 2017 WL 3726760 (9th Cir. Aug. 29, 2017). Chapter 13 Debtors were judicially estopped from asserting causes of action that both arose during the pendency of their bankruptcy and related to the bankruptcy because they failed to disclose the claims in their reorganization plan, schedules, and disclosure statements. Though Debtors appeared before the Bankruptcy Court to litigate those claims during the pendency of their Chapter 13 bankruptcy, "bankruptcy is a form driven process," and their un-amended schedules estopped their claims.

3. Collateral Estoppel—"Been There and Done That"

A. Definition

Collateral estoppel, commonly referred to as "issue preclusion," prevents re-litigation of the same issues between the same parties in different causes of action. It refers to the effect of findings of fact actually litigated in one lawsuit upon subsequent litigation which involves a different cause of action, but some or all of the same facts. *See* Restatement (Second) of Judgments § 27.

Unlike *res judicata*, also known as claim preclusion, collateral estoppel is narrower in scope because it only estops re-litigation of certain issues. *Res judicata*, in contrast, "prevents litigation of all grounds for, or defenses to, recovery that were previously available to the parties regardless of whether they were asserted or determined in the prior proceeding." *Brown v. Felsen*, 99 S.Ct. 2205, 2209 (1979).

Collateral estoppel relieves parties of the expense and vexation of attending multiple lawsuits, prevents needless duplication of effort and expense, conserves judicial resources, and fosters reliance on judicial action by minimizing the possibility of inconsistent decisions.

B. Elements

To establish collateral estoppel:

1. The party sought to be precluded in the second suit must have been a party, or in privity with a party, to the original lawsuit;

2. The issue sought to be precluded must be the same as the issue involved in the prior action;

3. The issue sought to be precluded must have been **actually litigated** in the prior action;

4. The issue sought to be precluded must have been determined by a valid and final judgment; and

5. The determination in the prior action must have been essential to the prior judgment.

Sells v. Porter (*In re Porter*), 539 F.3d 889, 894 (8th Cir. 2008) (quoting *Robinette v. Jones*, 476 F.3d 585, 589 (8th Cir.2007) (quotation omitted)) (emphasis added).

C. Special Issues

1. *Full Faith and Credit*–28 U.S.C. § 1738: A federal court must give to a state court judgment the same preclusive effect as would be given that judgment under the law of the state in which the judgment was rendered.

2. *Substantive Law of the State*: If the previous action was in state court, federal courts "look to the substantive law of the forum state in applying the collateral estoppel doctrine, giving a state court judgment preclusive effect if a court in that state would do so." *Fischer v. Scarborough* (*In re Scarborough*), 171 F.3d 638, 641 (8th Cir. 1999).

3. *Actually "Litigated" or "Decided"*:
   a. "If the same issue was actually litigated and determined by a final judgment, and was essential to that final judgment, it cannot be relitigated in bankruptcy court." *Roussel v. Clear Sky Props, LLC*, 829 F.3d 1043, 1047 (8th Cir. 2016).
   b. "An issue may be 'actually' decided even if it is not *explicitly* decided, for it may have constituted, logically or practically, a necessary component of the decision reached in the prior litigation." *Roussel v. Clear Sky Props, LLC*, 829 F.3d 1043, 1047 (8th Cir. 2016) (citing *In re Harper*, 378 B.R. 836, 849 (Bankr. E.D. Ark. 2007)) (emphasis original).

4. *Final Judgment or Adjudication*:
   a. An issue actually decided in a non-merits dismissal is given preclusive effect in a subsequent action between the same parties. *Robinette v. Jones*, 476 F.3d 585, 589 (8th Cir. 2007) (quoting *Miller v. Norris*, 247 F.3d 736, 740 (8th Cir. 2001) (in turn quoting *Pohlmann v. Bil-Jax, Inc.*, 176 F.3d 1110, 1112 (8th Cir. 1999)).
   b. Recent decisions have relaxed traditional views of the "finality requirement" in the collateral estoppel context by applying the doctrine to matters resolved by preliminary rulings or to determinations of liability that have not yet been completed by an award of damages or other relief. *Siemer v. Nangle* (*In re Nangle*), 274 F.3d 481, 484–85 (8th Cir. 2001).
   c. Despite the above trend, Debtor's prepetition dismissal of a state fraud action for failure to prosecute, a final judgment under state law, was not collaterally estopped to prevent re-litigating the fraud in Debtor's Chapter 7 bankruptcy case because the dismissal was not "final" for equitable estoppel purposes. *In re Hernandez*, 860 F.3d 591, 599-600 (8th Cir. 2017).

5. *Consent Judgments*:
   a. Generally, courts do not give consent judgments preclusive effect unless the parties have "'clearly shown that [they] intended to foreclose a particular issue in future litigation.'" *In re Bullard*, 451 B.R. 473 (E.D. Ark. 2011) (quoting *Coates v. Kelley*, 957 F.Supp. 1080, 1084-85 (E.D. Ark. 1997)).

b. No Missouri case has ever given a consent judgment collateral estoppel effect because consent judgments do not generally meet the "actually litigated" requirement. A consent judgment is "actually litigated" only if it is "on the merits" and if it is "rendered after argument and investigation and when it is determined which party is in the right, as distinguished from a judgment rendered upon some preliminary or technical point, or by default, and without trial." *In re Ferguson*, 2017 WL 562437, at *3 (Bankr. W.D. Mo. Feb. 10, 2017) (quoting *Metal Exch. Corp. v. J.W. Terrill, Inc.*, 173 S.W.3d 672, 677 (Mo. Ct. App. 2005).

c. However, a Bankruptcy Court may give a consent judgment preclusive effect if a party does not object to the underlying factual findings of a consent decree. By failing to contest a notice to admit in a state criminal fraud and embezzlement case, a consent judgment satisfied collateral estoppel's "actually litigated" requirement allowing the victim/creditor, from whom Debtor embezzled $350,000, to prevail on a motion for summary judgment in Debtor's Chapter 13 case, making the amount owed to her in restitution non-dischargeable under 11 U.S.C. § 523(a)(2). *Vizachero v. Brazieka* (*In re Brazieka*), 2017 WL 816871 (E.D. Mich. 2017).

6. *Default Judgments*:
   a. Generally, default judgments do not constitute "final judgments" for collateral estoppel purposes. *Restatement (Second) Judgments* § 27, comment e.
   b. However, a default judgment may be given preclusive effect if a defendant participated in the action and had a full and fair opportunity to defend on the merits. *Melnor, Inc. v. Corey* (*In re Corey*), 583 F.3d 1249 (10th Cir. 2009).

7. *Analyzing collateral estoppel issues*: If you have a prior judgment–
   a. Analyze the judgment itself
   b. Look at the underlying complaint(s)
   c. Analyze any indictments or plea agreements
   d. Analyze any restitution order(s)
   e. Analyze any jury instructions
      i. *Roussel v. Clear Sky Props, LLC*, 829 F.3d 1043, 1047 (8th Cir. 2016) (relying heavily on jury instruction to find maliciousness).
      ii. *Sells v. Porter* (*In re Porter*), 539 F.3d 889, 893 (8th Cir. 2008) (relying on jury instructions and findings to establish that the jury "necessarily" found all elements of willful and malicious injury for § 523(a)(6)).
   f. Attach key prior judgments and pleadings as exhibits to your complaint

D. Demonstrative Cases

1. *Phillips v. Phillips* (*In re Phillips*), 500 B.R. 570 (B.A.P. 8th Cir. 2013). The court rejected the argument that collateral estoppel could not apply to a state court findings because the matter was adjudicated post-petition.

2. *Sells v. Porter*, 539 F.3d 889 (8th Cir. 2008). In a nondischargeability action under 11 U.S.C. § 523(a)(6), a judgment entered in favor of a judgment creditor based on a claim that Debtor retaliated against the creditor for complaining about a co-employer's sexual harassment of her was given preclusive effect. Although the jury in the original action did not explicitly find that there was a willful and malicious injury by Debtor, the jury necessarily made these findings.

3. *Lovell v. Mixon*, 719 F.2d 1373 (8th Cir. 1983). Collateral estoppel did not apply to bar a trustee's action seeking to deny Debtor's discharge under 11 U.S.C. §727(a)(2). The intentional fraud issue was not decided by the Bankruptcy Court in a prior fraudulent transfer action where most of the claims were settled and dismissed and only the issue of constructive fraud was litigated.

4. *Lua v. Miller* (*In re Lua*), 2017 WL 2799989 (9th Cir. 2017). Equitable estoppel did not apply to prevent a Chapter 7 Debtor from reasserting a homestead exemption in her second amended schedule after she had disclaimed the homestead exemption in her first amended schedule. The Court of Appeals held that the Bankruptcy Court abused its discretion in holding that equitable estoppel barred Debtor from claiming the homestead exemption because a schedule may be amended "at any time" during the case, so Trustee could not have relied on the assumption that Debtor would not later re-claim the homestead exemption. A dissenting opinion suggested that the Bankruptcy Court had not abused its discretion, noting Debtor "stood idly by as the Trustee toiled away" to monetize the property, and therefore suggesting the equities weighed in favor of denying her the homestead exemption.

4. Equitable Mootness—"Finality"

A. Definition

Also called "prudential" or "pragmatic" mootness, equitable mootness is a doctrine developed by appellate courts reviewing bankruptcy cases which allows an appellate court to dismiss a challenge as moot, based on equitable grounds, even though effective relief could conceivably be fashioned. *Williams v. Citifinancial Mortgage Co.* (*In re Williams*), 256 B.R. 885, 896 (B.A.P. 8th Cir. 2001) (citing *Blackwell v. Little* (*In re Little*), 253 B.R. 427, 430 (B.A.P. 8th Cir. 2000)). *See also Rich Dad Operating Co., LLC v. Zubrod,* (*In re Rich Global, LLC*), 652 Fed.Appx. 625, 629 (10th Cir. 2016) ("[E]quitable, prudential, or pragmatic considerations can render an appeal of a bankruptcy court decision moot even when the appeal is not constitutionally moot.") (citation omitted).

The appellate court asks "whether an unwarranted or repeated failure to request a stay enabled developments to evolve in reliance on the bankruptcy court's order to the degree that their remediation has become impracticable or impossible." *Williams v. Citifinancial Mortgage Co.* (*In re Williams*), 256 B.R. 885, 896 (B.A.P. 8th Cir. 2001).

B. Equitable Mootness Distinguished

1. *Equitable Mootness*: "In the bankruptcy context, equitable mootness may also be a consideration. Under this doctrine, 'equitable, prudential, or pragmatic considerations can render an appeal of a bankruptcy court decision moot even though the appeal is not constitutionally moot.'" *Rich Dad Operating Co. v. Zubrod* (*In re Rich Global, LLC*), 652 Fed.Appx. 625, 629 (10th Cir. 2016).

2. *Constitutional Mootness*: An appeal is constitutionally moot if the court can fashion no meaningful relief. *Rich Dad Operating Co. v. Zubrod* (*In re Rich Global, LLC*), 652 Fed.Appx. 625, 628 (10th Cir. 2016).
   a. Constitutional mootness presents a jurisdictional issue, while equitable mootness does not. *See In re Ferguson,* 683 F. App'x 924, 927 (11th Cir. 2017) (declining to consider whether a case could be dismissed as equitably moot because the doctrine is discretionary) (equitable mootness "bears only upon the proper remedy, and does not raise a threshold question of our power to rule") (internal citations omitted).

3. *Statutory Mootness*: "Statutory mootness" occurs when a statute, such as 11 U.S.C. § 363(m) or § 364(e), limits the relief an appellate court can dispense based on the occurrence of certain events while the appeal is pending and in the absence of a stay pending appeal. *Williams v. Citifinancial Mortgage Co.* (*In re Williams*), 256 B.R. 885, 896 (B.A.P. 8th Cir. 2001).

C. Application

1. Equitable mootness is most often applied after plan confirmation where the plan has been substantially consummated and a party seeks appellate review of an issue, that, if upset, would unduly disturb the plan. *Williams v. Citifinancial Mortgage Co.* (*In re Williams*), 256 B.R. 885, 896 (B.A.P. 8th Cir. 2001).

2. Courts are currently split regarding whether the risk of mootness, standing alone, can cause "irreparable harm" sufficient to justify a stay of the confirmation order. The Eighth Circuit has not yet considered the issue. *In re Peabody Energy Corp.*, No. 4:17-CV-01053-AGF, 2017 WL 1177911, at *6 (E.D. Mo. Mar. 30, 2017).[2]

3. The choice to apply equitable mootness is discretionary, and courts often decline to consider the doctrine entirely. *See C.O.P. Coal Dev. Co v. C.W. Mining Co.* (*In re C.W. Mining Co.*), 641 F.3d 1235, 1240 (10th Cir. 2011) (concluding "[e]ven if [equitable mootness doctrine] does apply, we are not required to do so as it is discretionary with the court. . . . Rather than decide whether the doctrine can be applied, and, if so, weigh the doctrine's six factors in this case in the face of an underdeveloped record on this issue, we think the better and more appropriate course is to resolve this appeal on the merits.").[3]

[2] *See, e.g.*, EPlus, Inc. v. Katz (*In re* Metiom, Inc.), 318 B.R. 263, 271 (Bankr. S.D.N.Y. 2004) ("failure to satisfy one prong of the standard ... dooms the motion"). *See also In re* Tower Automotive, Inc., No. 05–10578, 2006 WL 2583624, at *1 (Bankr. S.D.N.Y. June 28, 2006) ("all four criteria must be satisfied to some extent before a stay is granted"); *In re* Baker, No. 05 Civ. 3487, 2005 WL 2105802, at *3 (Bankr. E.D.N.Y. Aug. 31, 2005) (same).

[3] *See also In re* Gretter Autoland, Inc., 864 F.3d 888, 891 (8th Cir. 2017) ("We need not address the parties' dispute about the nature and shape of the so-called equitable mootness doctrine because we conclude that the case is moot in the ordinary sense."); *In re* Ferguson, 683 F. App'x 924, 927 (11th Cir. 2017) ("Though Ferguson urges us to do so, we will not undertake such an analysis here because the doctrine is discretionary and does not divest us of jurisdiction"); Bank of New York Mellon v. Watt, No. 15-35484, 2017 WL 3496034, at *4 (9th Cir. Aug. 16, 2017) ("We do not address whether an appeal following the § 363 sale would have been equitably moot. The prudential doctrine of equitable mootness may apply when bankruptcy cases 'present transactions that are so complex or difficult to unwind.'").

4. The doctrine of equitable mootness applies to Chapter 9 cases. *In re City of Detroit, Michigan*, 838 F.3d 792, 798 (6th Cir. 2016), *cert. denied sub nom. Ochadleus v. City of Detroit, Mich.*, 137 S. Ct. 1584 (2017), and *cert. denied sub nom. Quinn v. City of Detroit, Mich.*, 137 S. Ct. 2270 (2017*). See also Alexander v. Barnwell Cty. Hosp*., 498 B.R. 550 (D.S.C. 2013); *In re* City of Vallejo, 551 Fed.Appx. 339 (9th Cir. 2013); *In re City of Stockton*, 542 B.R. 261, 273–74 (B.A.P. 9th Cir. 2015).

5. "Before there is a basis to forgo jurisdiction, granting relief on appeal must be almost certain to produce a perverse outcome—chaos in the bankruptcy court from a plan in tatters and/or significant injury to third parties. Only then is equitable mootness a valid consideration." *In re Millennium Lab Holdings II*, *LLC*, No. 16–110–LPS, 2017 WL 1032992, at *11(D. Del. Mar. 20, 2017), as amended (quoting *In re SemCrude*, 728 F.3d 314, 320 (3d Cir. 2013)).

D. Purpose

1. "In bankruptcy proceedings, the equitable component centers on the important public policy favoring orderly reorganization and settlement of debtor estates by affording finality to the judgments of the bankruptcy court" and for third parties to rely on that finality. *See In re Pub. Serv. Co. of New Hampshire*, 963 F.2d 469, 471–72 (1st Cir. 1992) (internal quotations omitted).

2. The equitable mootness doctrine seeks to avoid an appellate decision that "would knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the Bankruptcy Court." *In re Nica Holdings, Inc.*, 810 F.3d 781, 787 (11th Cir. 2015).

E. Factors

1. Whether the plan has been substantially consummated;
2. Whether there is a stay pending appeal;
3. Whether the relief requested would affect the rights of parties not before the Court;
4. Whether the relief requested would affect the success of the confirmed plan;
5. The public policy of affording finality to bankruptcy court judgments; and
6. Whether the parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings.

In re Williams, 256 B.R. 885, 896 n. 11 (B.A.P. 8th Cir. 2001).

7. Alternative Factor Tests:
   a. The Third Circuit has collapsed the factors listed above into the following two part analysis: "(1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation." *In re Tribune Media Co.*, 799 F.3d 272, 278 (3d Cir. 2015).
   b. The Sixth Circuit has broken the test into three factors: "(1) whether a stay has been obtained; (2) whether the plan has been 'substantially consummated'; and (3) whether the relief requested would significantly and irrevocably disrupt the implementation of the plan or disproportionately harm the reliance interests of other parties not before the court." *In re City of Detroit, Michigan*, 838 F.3d 792, 798 (6th Cir. 2016), *cert. denied sub nom. Ochadleus v. City of Detroit, Mich.*, 137 S. Ct. 1584, and c*ert. denied sub nom. Quinn v. City of Detroit, Mich.*, 137 S. Ct. 2270 (2017) (citing *In re United Producers*, 526 F.3d 942, 947–48 (quotation marks and citations omitted). "The most important factor is whether the relief requested would affect the rights of third parties or the overall success of the plan." *Id.* at 799.

F. Special Issues

1. The Seventh Circuit does not apply equitable mootness to dismiss an appeal after a plan has been confirmed. *See United States v. Buchman*, 646 F.3d 409, 411 (7th Cir. 2011) ("[T]his circuit does not follow that approach. We have held that the possibility of financial adjustments among the parties keeps a proceeding alive even if the sale cannot be upset and rights under a plan of reorganization cannot be revised."). Instead, the Seventh Circuit hears such appeals and carefully fashions alternative equitable remedies that protects interested third parties. *See id.*

2. On appeal of certain types of orders entered in bankruptcy cases—such as orders authorizing the sale or lease of property, orders terminating the automatic stay to allow foreclosure, confirmation orders, and orders authorizing post-petition financing—the importance of a motion to stay the proceedings pending appeal cannot be overstated.

3. When drafting a plan, think carefully about defining terms like "Final Order" and whether the plan can become effective and be substantially consummated even if someone appeals the confirmation order but does not obtain a stay pending appeal.

G. Demonstrative Cases

1. *Zeeger v. Pres. Casinos, Inc.* (*In re Pres. Casinos, Inc.*), 2010 WL 582794 (E.D. Mo. Feb. 16, 2010), *aff'd* Fed. Appx. 31 (Nov. 5, 2010) (citation omitted). In the context of an appeal of a confirmed plan "an appellate court may dismiss an appeal of a confirmation order where 'there has been substantial consummation of the plan such that effective judicial relief is no longer available' even where a controversy may still exist between the parties."

2. *La'Teacha Tigue v. Sosne* (*In re La'Teacha Tigue*), 363 B.R. 67 (B.A.P. 8th Cir. 2007). Debtor's appeal of the court's decision to approve a settlement between a creditor and Trustee was not equitably moot where unwinding the settlement would not be impracticable or impossible. All affected parties were parties to the appeal and presumably had funds to restore the status quo ante.

3. *Blackwell v. Little* (*In re Little*), 253 B.R. 427 (B.A.P. 8th Cir. 2000). The bankruptcy court entered an order granting Debtor's motion to convert Debtor's case to Chapter 13. Trustee's appeal of that order was moot because an order was entered confirming Debtor's Chapter 13 plan and Trustee began making payments to claimants. The plan confirmation order was not stayed or appealed. "[T]he failure to obtain a stay of the plan confirmation order renders it inequitable to attempt to place the parties in the same positions."

4. *JMC Memphis, LLC V. Kapila* (*In re JMC Memphis, LLC*), 655 Fed.Appx. 802 (11th Cir. July 21, 2016). Appeal of an order approving a settlement by a non-party to the settlement was equitably moot when the appellant failed to obtain a stay pending appeal, the parties began consummation of the settlement, and the appellant had previously failed to exercise due diligence to protect its rights.

5. *Capital Factors, Inc. v. Kmart Corp.* (*In re Kmart Corp.*), 291 B.R. 818 (N.D. Ill. 2003), *aff'd In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004)). Appeal of critical vendor order and similar orders was not equitably moot where it was not too late to order return of monies paid and obtaining return of funds would not be unduly burdensome.

6. *In re City of Detroit, Michigan*, 838 F.3d 792, 798 (6th Cir. 2016), *cert. denied sub nom. Ochadleus v. City of Detroit, Mich.*, 137 S. Ct. 1584 (2017), and *cert. denied sub nom. Quinn v. City of Detroit, Mich.*, 137 S. Ct. 2270 (2017). The Sixth Circuit denied a group of participants in Detroit's General Retirement System ("GRS") the opportunity to appeal the City's Chapter 9 plan confirmation on equitable estoppel grounds. The appeal was equitably moot because it would undo several complex real estate transactions, internal changes to the City's governance, and other completed deals including a "Grand Bargain" in which the City reduced the GRS participants' promised pension benefits by 4% and reinvested the freed revenue in complex deals to improve the City's infrastructure and city planning. The Sixth Circuit reasoned that all three factors weighed in favor of denying the appeal on equitable mootness grounds: (1) the participants did not obtain a stay, (2) the changes the City made and deals it undertook rendered its plan substantially completed, and (3) granting the appeal "would necessarily rescind the Grand Bargain, . . . the series of other settlements and agreements contingent upon the Global Retiree Settlement, . . . [and unravel] the entire Plan and adversely affect[] countless third parties . . . ."

7. *In re One2One Commc'ns, LLC*, 805 F.3d 428 (3d Cir. 2015). The Third Circuit reversed the district court's dismissal of an appeal as equitably moot because—though the plan had been substantially completed and Debtor had transferred property to third parties—the transactions involved would not be difficult to unravel, did not involve the sale of any publicly traded securities, and Debtor failed to prove that any third party had detrimentally relied on the completed transactions.

8. *In re Hujazi*, No. BAP NC-15-1206-BSKU, 2017 WL 2980257 (B.A.P. 9th Cir. July 12, 2017). Debtor's motions for violations of the automatic stay were equitably mooted by sales of realty to third parties.

What Happens When a Debtor Dies During a Pending Case?

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Death of a Debtor During a Pending Bankruptcy Case.

One of the central purposes of the Bankruptcy Code ("the Code") is to provide a debtor with a "fresh start."[1] To begin the process of achieving a fresh start, a debtor must follow the procedures set out in one of several different Chapters provided under the Code.[2] Under the provisions in every Chapter, a bankruptcy case can take anywhere from several months (Chapter 7) to several years (Chapter 13) from the filing of a petition to granting a discharge.[3]

The length of time required to complete the provisions under various Chapters and receive a discharge is necessary to the long-term financial success of those filing for bankruptcy.[4] The Code does not contemplate, however, that many debtors are either elderly or suffering from a chronic medical condition.[5] As a result, the death of a debtor during a pending bankruptcy case is not an uncommon occurrence.[6]

When a debtor dies during a pending bankruptcy case, the fresh start is often rendered somewhat useless, as the debtor no longer needs it.[7] This frustrates the purpose of the Code.[8] Further, although death during bankruptcy is far from atypical, the current version of the Code does not directly address the issue in any of its provisions.[9] These two factors create a host of issues for attorneys, family members of the debtor, and creditors, because exactly what to do and how to proceed in these cases is often very unclear.[10]

Federal Rule of Bankruptcy Procedure 1016.

There was not always such a lack of instruction as to what to do in the event of a debtor's death during a pending case.[11] Until 1978, the Bankruptcy Act of 1898 provided guidance on what to do in the event of a death, stating "[t]he death or insanity of a bankrupt shall not abate the proceedings but the same shall be conducted and concluded in the same manner, so far as

possible, as though he had not died . . ."[12] In 1978, the Code was amended to its current form and the provision regarding death was seen as "unnecessary"[13] and removed from the Code.[14]

With the removal of the original provision, the Code no longer contains any specific language regarding the death of a debtor.[15] Federal Rule of Bankruptcy Procedure 1016, however, is similar to the rule previously found in the Bankruptcy Act of 1898 and does provide some instruction for those involved in the case after the death.[16] Rule 1016 states:

> Death or incompetency of the debtor shall not abate a liquidation case under chapter 7 of the Code. In such event the estate shall be administered and the case concluded in the same manner, so far as possible, as though the death or incompetency had not occurred. If a reorganization, family farmer's debt adjustment, or individual's debt adjustment case is pending under chapter 11, chapter 12 or chapter 13, the case may be dismissed; or if further administration is possible and in the best interest of the parties, the case may proceed and be concluded in the same manner, so far as possible, as though the death or incompetency had not occurred.[17]

Rule 1016, however, has been interpreted in a variety of different ways under various circumstances and Chapters of the Code since its inception, resulting in a very non-uniform area of bankruptcy law.[18] As a result, many attorneys are left wondering what to do next when a debtor client dies prior to discharge of their case.[19] Depending on the Chapter of the Code at issue in the case, the procedure and results can vary widely.[20] Some courts do require a filing of a notification and a death certificate of the debtor, but this requirement is under Federal Rule of Bankruptcy Procedure 7025.[21]

The Scope of Federal Rule of Bankruptcy Procedure Rule 1016.

The application of Rule 1016 differs by Chapter of the Code,[22] but in general, the language of the Rule "clarifies that a continuing bankruptcy case is possible after a debtor's death."[23] Even though the debtor no longer needs the "fresh start" offered by the provisions of

the Code, many courts have continued bankruptcy cases after a debtor's death under appropriate circumstances.[24] Although issues in other chapters of the Code occasionally arise, most issues regarding death of a debtor arise within Chapter 7 and Chapter 13 cases, and thus will be the focus of these materials.[25]

Issues in Chapter 7 Cases.

Continuing a Chapter 7 Case after the Death of a Debtor.

Courts examining Rule 1016 in the context of a Chapter 7 case have interpreted its language to mean that "a Chapter 7 bankruptcy case is intended to proceed to conclusion despite the death of the debtor."[26] Because of the lack of direct involvement in a Chapter 7 case by a debtor, especially in comparison to a Chapter 13 case, this approach is feasible.[27] In a Chapter 7 case wherein the debtor is alive, the debtor has little, if any, involvement in the proceedings after the appointment of the Chapter 7 trustee.[28] The Bankruptcy Court for the District of Colorado noted in *In re Waring* that "unless the Chapter 7 estate is solvent, a debtor typically does not even have standing to participate in matters concerning administration of the bankruptcy estate."[29] The death of a debtor in a Chapter 7 case, therefore, will not significantly impact the ordinary course of the proceedings already in motion.[30]

Despite the ability of a Chapter 7 case to proceed virtually undisturbed after the death of a debtor, other issues do arise in these cases with some regularity.[31] This section will address some of the major issues that practitioners are likely to encounter after the death of a debtor during a pending Chapter 7 bankruptcy case.

Death of a Debtor Prior to Completion of Personal Financial Management Course.

Section 727(a)(11) of the Code requires that a discharge may not be granted to a debtor who failed to complete a personal financial management course.[32] This requirement presents a frequent problem in bankruptcy cases, particularly Chapter 7 cases, when the debtor dies prior to completing an appropriate course.[33] This situation impedes Rule 1016's directive that the Chapter 7 case should continue as though the debtor had not died.[34]

Section 727(a)(11) does provide a relevant exception to this situation, and states " . . . this paragraph shall not apply with respect to a debtor who is a person described in section 109(h)(4) . . ."[35] Section 109(h)(4) provides an exemption for debtors who are "unable to complete [the] requirements because of incapacity, disability, or active military duty in a military combat zone."[36]

The general rule regarding debtors who die prior to completing the personal financial management course is that the debtor is considered to be "'incapacitated' or 'disabled' under 11 U.S.C. § 109(h)(4)."[37] A recent case regarding this issue is *In re Pollard*, in which the debtor died less than two months after filing her Chapter 7 bankruptcy petition.[38] Because the debtor died shortly after the petition was filed, she did not complete the financial management course.[39] The Bankruptcy Court for the Middle District of North Carolina, Winston-Salem division, cited to several other cases in which courts held that the debtor was "'incapacitated' or 'disabled' under 11 U.S.C. § 109(h)(4)."[40] The court determined that the debtor's death was cause to waive the personal financial management course, especially in light of Rule 1016's directive that a Chapter 7 case proceed as though the death never occurred.[41] As such, a debtor who dies prior to

completing the financial personal financial management course will generally be waived out of the requirement and allowed to obtain a discharge under Chapter 7 of the Code.[42]

What is Considered Property of the Estate.

Rule 1016 directs that a Chapter 7 case in which a debtor dies prior to a discharge should proceed as though the death never occurred.[43] Courts have accomplished this directive by generally holding that under § 541 of the Code, "the bankruptcy estate, with a few exceptions, consists of 'all legal or equitable interests of the debtor in property' that existed 'as of the commencement of the case' along with certain after acquired property rights that come in the estate via Section 541(a)(5)."[44] This approach accomplishes Rule 1016's directive and does not disturb the case proceedings after a debtor's death.[45]

If a debtor dies within 180 days of filing the petition, however, life insurance proceeds may become property of the estate under § 541(a)(5)(C) of the Code.[46] The Bankruptcy Court for the Western District of Missouri ruled on the issue in *In re Bauer*, a 2006 case.[47] In the case, a husband and wife filed for Chapter 7 bankruptcy on September 23, 2005.[48] The debtors both died in a car accident on November 27, 2005.[49] The debtors each had life insurance policies and the Trustee filed an adversary action against the estate administrator, seeking to include the policies in the property of the estate under § 541(a)(5).[50] The estate administrator sought to suspend the proceedings under § 305 of the Code, which provides "that the court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a cause under this title if 'the interests of creditors and the debtor would be better served by such dismissal or suspension.'"[51]

Ultimately, the court in *In re Bauer* did not suspend the proceedings because Rule 1016 requires that a Chapter 7 case proceed as though the deaths did not occur.[52] The court upheld the general viewpoint that the bankruptcy estate will remain undisturbed and exempt assets will go into the debtor's probate estate, subject to certain exceptions.[53] Under § 541(a)(5)(C) of the Code, life insurance proceeds acquired within 180 days of the petition date are one of those exceptions.[54] Because they did not consolidate their bankruptcy estates after filing a joint petition, the debtors in *Bauer* had two separate bankruptcy estates, one of which was entitled to the life insurance proceeds of the spouse who survived the other.[55] Further, the deaths occurred within 180 days after the petition date.[56] The court noted that if it could be determined which debtor survived the other, that debtor's estate would be entitled to the proceeds, which would then become property of the bankruptcy estate.[57] Although the bankruptcy estate will generally remain undisturbed in a Chapter 7 case, life insurance proceeds can potentially be included in the estate after death if within the appropriate statutory timeframe.[58]

Exemptions Applicable to the Debtor.

Another prescient issue in the context of a Chapter 7 debtor who dies during a pending case is whether the exemptions the debtor claimed when filing the bankruptcy petition still apply after the debtor's death.[59] Courts have held that generally, the exemptions claimed at the time of the bankruptcy filing will continue to apply after debtor's death.[60]

In *In re Peterson*, the 8th Circuit upheld a homestead exemption claimed by the debtor at the time of his Chapter 7 filing.[61] At the time of his filing, the debtor was not married but did have one dependent child, enabling him to qualify for a homestead exemption under North Dakota law.[62] The debtor died during his pending bankruptcy case without leaving a surviving

spouse or a dependent child.[63] The Trustee in the case contended that the homestead exemption was invalid as to the debtor's case after his death and the property reverted back to the bankruptcy estate.[64]

The 8th Circuit held that "the law as it exists on the date of filing determines a debtor's claimed exemption."[65] The 8th Circuit cited several other cases in support of this holding, all of which concluded that the exemptions that existed at the time of the bankruptcy filing were the only ones that applied to the debtor after death.[66] The importance of Rule 1016's directive that a Chapter 7 bankruptcy case should be continued as though death never occurred was also emphasized through the holding, as the exemptions would not have been in question if the debtor were still alive.[67] Lastly, the 8th Circuit noted that § 522(b)(2)(A) of the Code directs that state law exemptions are determined on the date of filing and as such, exemptions should be determined as of the date of the filing of the bankruptcy petition.[68]

Converting a Chapter 13 Case to Chapter 7 After a Debtor's Death.

After a debtor dies during a pending Chapter 13 bankruptcy case, the question of whether the case can be converted to another Chapter of the Code by an estate administrator may arise.[69] This issue arises when a debtor's estate attempts to convert the Chapter 13 case to a Chapter 7 case because it provides for an easier route to obtaining a discharge after a debtor's death.[70] Generally, only a debtor is able to convert a case from a Chapter 13 to a Chapter 7 under § 1307(a) of the Code.[71] As a result, the question of whether an administrator may move to convert a case after a debtor's death under Rule 1016 has been examined by various courts.[72]

In 2009, the Bankruptcy Court for the Northern District of Oklahoma heard *In re Hancock*, a case in which the debtor's non-filing spouse attempted to convert her Chapter 13

case to a Chapter 7 case after her death.[73] The debtor's Chapter 13 plan was confirmed prior to her death.[74] Shortly after her death, the debtor's husband and his attorney sought to convert the case to a Chapter 7 proceeding because the debtor originally wanted to file under Chapter 7, but could not because she did not meet the income requirements.[75] The debtor's attorney also reasoned that converting the case would allow the debtor's husband to "move on with his life knowing that Debtor's debts had been discharged."[76] The Trustee filed a motion to dismiss, contending, among other reasons, that 1) Rule 1016 does not permit after-death conversion of a bankruptcy case and 2) only a person is eligible to be a debtor under Chapter 7, and as such, the debtor's attorney could not move for conversion after her death.[77]

The *Hancock* court opted to not decide the issue of whether the attorney had the power to move for conversion in the case after the debtor's death, but noted that other courts who examined the issue "have held that the administrator of a decedent's estate may not convert a Chapter 13 case to a case under Chapter 7 because only a 'debtor' may convert a case."[78] Further, the court noted that other courts examining similar issues decided only a person may be a debtor under § 109(a) of the Code, and that an estate is not a person under § 101(41).[79]

The court did decide, however, that the debtor's attorney did not prove that converting the case to a Chapter 7 was "in the best interests of the parties to 'proceed . . . as though the death had not occurred.'"[80] Because the debtor was dead, the court reasoned that she could not take advantage of the fresh start offered by Chapter 7.[81] The court also looked to the best interests of the creditors in the case.[82] The debtor exempted all of her property of the estate, and as a result, if the case was converted to Chapter 7, there would be nothing to liquidate.[83] Because the debtor's husband was not liable on any of the debtor's unsecured debts, his best interests were not considered by the court.[84] Ultimately, the court dismissed the Chapter 13 case

without converting it to a Chapter 7 case because conversion was not in the best interests of the parties.[85]

Issues in Chapter 13 Cases.

Continuing a Chapter 13 Case after the Death of a Debtor.

Although Rule 1016 provides specific guidance as to what to do in the event that a Chapter 7 debtor dies during their case, the Rule is less clear as to Chapters 11, 12, and 13.[86] Rule 1016 states: " . . . [i]f a reorganization, family farmer's debt adjustment, or individual's debt adjustment case is pending under chapter 11, chapter 12, or chapter 13, the case may be dismissed; or if further administration is possible and in the best interest of the parties, the case may proceed and be concluded in the same manner, so far as possible, as though the death or incompetency had not occurred."[87]

Unlike Chapter 7 cases, the normal course of action after the death of a debtor in an ongoing Chapter 13 case is to simply dismiss the plan, especially if the death occurs early on in the case.[88] A Chapter 7 case requires virtually no participation of a debtor, regardless of whether they are living.[89] Because a Chapter 13 case requires that a "debtor play[] a central and ongoing role, from the filing of the petition through discharge some three to five years later,"[90] it is considerably more difficult to continue the case after a debtor's death.[91] As such, the Advisory Committee's Note in regard to Rule 1016 states that "[i]n a chapter 11 reorganization case or a chapter 13 individual's debt adjustment case, the likelihood is that the case will be dismissed."[92]

The Advisory Committee's Note, however, should not be taken to mean that courts should dismiss a Chapter 13 debtor's case upon death.[93] Courts have interpreted Rule 1016 and the Advisory Committee Note over the years, and what has emerged is a general viewpoint that

the timing of the debtor's death matters in regard to whether the case will be dismissed.[94] If the debtor dies early in the case, the chances of dismissal are higher.[95] If the debtor dies later on in the case, however, the chances of dismissal diminish.[96] In a case where the debtor dies after confirmation of the plan or near completion of the plan, a court will look to the best interests of creditors to determine whether the case should continue on to completion.[97] This section will address both of these situations, as well as other issues practitioners should be aware of when faced with the death of a debtor during a Chapter 13 case.[98]

Death Before Attending the Required Meeting of Creditors or Confirmation of the Chapter 13 Plan.

One of the cornerstones of a Chapter 13 bankruptcy case is the required meeting of creditors.[99] Although this meeting generally occurs shortly after the filing of the bankruptcy case, debtors frequently pass away soon after filing their petition, making them unable to attend the meeting.[100] If a debtor dies so soon after filing the petition that they do not attend their meeting of creditors, they will also not see confirmation of the plan.[101] The question of what to do in situations such as these has been examined over the years, and generally, courts dismiss these cases.[102]

In 2016, the Bankruptcy Court for the District of Colorado upheld this viewpoint in *In re Waring*.[103] The debtor in the case ("Mr. Waring") died 26 days after filing his Chapter 13 bankruptcy petition and thus was unable to attend the meeting of creditors, nor did he live to see confirmation of the plan.[104] Mr. Waring filed the petition with his wife, and she sought to continue the case after his death.[105] After an objection to the original plan, Mr. Waring's wife filed an amended plan.[106] The amended plan included Mr. Waring.[107]

The court considered whether to dismiss the case, particularly in light of the fact that the petition was filed by joint debtors.[108] Even though the default action generally is to dismiss the case,[109] many courts consider whether "further administration" of the case is possible under the facts.[110] The court defined further administration as "tasks that are more limited than prosecution of the entire Chapter 13 bankruptcy case from the very beginning including attendance at the § 341 meeting, proposing a Chapter 13 plan, and prosecuting the proposed Chapter 13 plan to confirmation."[111] Further administration of the bankruptcy estate is possible after a debtor's death "if there is a source of payments or sufficient payments have been made such that a discharge may be warranted."[112]

Further administration, however, is generally "impossible if a debtor dies before confirmation of a Chapter 13 plan, because no terms for administration of the estate have been established."[113] Mr. Waring's death prior to confirmation of the plan was the impetus for the court's decision to dismiss him from the case.[114] The fact that a joint petition was filed was also not enough to prevent dismissal, as the bankruptcy estates were not consolidated into one estate.[115] Finally, the court determined that because Mr. Waring was deceased, he could not benefit from the fresh start provided by a bankruptcy discharge.[116] It should be noted, however, that Mr. Waring's wife was given the option to proceed as a separate Chapter 13 debtor in the case or to dismiss the case.[117]

Because the proceedings in a Chapter 13 case "require[] the active participation of a debtor at all stages and for years,"[118] courts generally follow the *Waring* line of reasoning in determining whether to dismiss a case after the death of a debtor early on in the case, regardless of the parties' best interests.[119] In *In re Martinez*, the Bankruptcy Court for the Western District of Texas, San Antonio division, dismissed a debtor's case after he passed away prior to

confirmation of his Chapter 13 plan.[120] After his death, his attorney attempted to file an amended plan.[121] The court concluded that Rule 1016 prevented the further administration of his case because the debtor did not propose the plan himself, and "only a debtor may propose a plan."[122] Although the debtor had a special needs son, the court concluded that the best interests of the parties could not outweigh the general viewpoint that further administration is impossible in a Chapter 13 case without a confirmed plan prior to the debtor's death.[123] As such, if a debtor dies so early on in the case that the plan has not yet been confirmed, dismissal is the most likely outcome.[124]

There are very rare cases, however, in which a debtor's plan is confirmed after death.[125] The Bankruptcy Court for the Eastern District of Pennsylvania confirmed one such plan in *In re Terry*.[126] In that case, however, the plan was being funded by the debtor's sister and was therefore not dependent on the debtor's income to fund the plan to completion.[127] Because of the funding and the fact that the Plan provided for a 100% distribution to the debtor's creditors, the court determined that it was in the best interests of the parties to not dismiss the case because further administration was possible under Rule 1016.[128] This scenario, however, appears to be exceedingly rare.[129]

Death of a Debtor After Confirmation of a Chapter 13 Plan.

When a debtor dies after the confirmation of a Chapter 13 plan, dismissal is not necessarily as certain as it is in a case in which the debtor dies prior to plan confirmation.[130] Below are several issues that arise when the debtor dies after confirmation of the Chapter 13 plan.

Whether a Personal Representative May Complete Plan Payments on Behalf of a Debtor.

If the plan was confirmed prior to death, some courts hold that a debtor's personal representative may be able to complete the plan payments, even if the death occurs shortly after plan confirmation.[131] Allowing the appointment of a personal representative, however, varies by court.[132] In *In re Fogel*, the debtor's wife ("Mrs. Fogel") was allowed to operate as his personal representative in the bankruptcy case after his death.[133] The Chapter 13 plan was confirmed while the debtor was still alive, and he made three payments under the plan before passing away.[134] Mrs. Fogel continued to make plan payments, and after she completed the plan, informed the Trustee of the debtor's death.[135] After receiving the certification form to receive a discharge, Mrs. Fogel was made aware that she could not file the form because the debtor had not completed the personal financial management course required by the Code.[136]

The Bankruptcy Court for the District of Colorado denied Mrs. Fogel's motion to waive the requirement of the personal financial management course and sua sponte dismissed the case, determining that "dismissal is mandatory in the case of a sole Chapter 13 debtor who dies before receiving a discharge and second, that a deceased debtor's spouse cannot act on the debtor's behalf even if she is appointed as personal representative of the debtor's estate."[137] Mrs. Fogel appealed after her motion to reconsider was denied[138] and the case was then heard by the District Court for the District of Colorado.[139]

The court determined that both reasons for the bankruptcy court's dismissal were "factually incorrect."[140] Under Rule 1016, further administration of the case must be considered if it is both feasible and in the best interests of the parties.[141] The specific facts of the case at

hand, however, must be what is considered by the court.[142] In this instance, the plan was already confirmed at the time of the debtor's death, and the debtor's income was not the sole source of funding to make plan payments.[143] If a source other than the deceased debtor's income exists that can be used to make plan payments, that source may be able to make the plan payments.[144]

As to the issue of whether a deceased debtor may have a personal representative administer his bankruptcy case, the court relied on *In re Kosinski*, a 2015 case from the Northern District of Illinois that reasoned "[i]f no party could ever act on behalf of a deceased debtor because there is no separate rule specifically providing for formal substitution, the provisions in Rule 1016 allowing a case to continue after a debtor's death would be meaningless."[145] The court agreed with the reasoning in *Kosinski* and concluded that "pursuant to Federal Rule of Bankruptcy Procedure 1016, an appropriate person may represent a debtor after his or her death."[146] The court also found that under § 109(h)(4) of the Code, the debtor was able to waive the requirement of the personal financial management course.[147] The case was ultimately remanded.[148]

Other courts have recently spoken on this issue in cases with similar fact patterns, and have concluded that Rule 1016's language may imply that a deceased debtor has to have a personal representative act on their behalf in order to achieve the Rule's directive.[149] Other courts, however, have been more cautious in regard to this issue stating "[t]he better approach is to decide who may act on a case-by-case basis."[150]As such, a strong argument exists that pursuant to Rule 1016, a deceased debtor may be represented by a personal representative in the bankruptcy proceedings.[151]

Whether a Deceased Debtor May Receive a Discharge in a Chapter 13 Case.

Despite the fact that a deceased debtor does not personally benefit from a discharge, many courts have held that a discharge may be granted if the plan is completed by the debtor's personal representative.[152] In 2007, this viewpoint was further established by the Bankruptcy Court for the Southern District of Illinois in *In re Perkins*.[153] The debtor in *Perkins* died during the pendency of his Chapter 13 case, but after confirmation of the plan.[154] The Trustee in the case asserted that the debtor could not be granted a discharge in the case because "there [was] no debtor to whom the discharge would be granted."[155] The *Perkins* court reasoned, however, that because the language of Rule 1016 directs that when possible, bankruptcy cases proceed as though the debtor was still alive, the Rule must allow a discharge because a debtor who is not deceased may receive a discharge in the course of an ordinary Chapter 13 proceeding.[156] The Trustee in *Perkins* further asserted that under § 109(e), the term "debtor" did not include deceased debtors as used in § 1328(a).[157] The court rejected this analysis, however, deciding that a debtor's eligibility is determined on the date of the filing of the petition.[158]

In 2011, the Bankruptcy Court for the District of Colorado agreed with the *Perkins* court and granted a deceased Chapter 13 debtor a discharge in *In re Fuller*.[159] As such, the general view is that a discharge may be granted to a deceased Chapter 13 debtor so long as the plan was confirmed prior to death and is properly completed.[160]

Whether a Hardship Discharge May be Granted.

One final issue in Chapter 13 cases is whether a hardship discharge may be granted to a debtor who passes away before the conclusion of his case.[161] A hardship discharge can be granted under § 1328(b) of the Code "at any time after confirmation of a plan, even when plan

payments have not been completed."[162] In order to receive a hardship discharge, a debtor must prove the following:

> (1) the Debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
> (2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and
> (3) modification of the plan under section 1329 of this title is not practicable.[163]

Although courts are divided on whether a hardship discharge may be granted to a deceased debtor, a recent case out of the Bankruptcy Court for the District of Kansas provides a good discussion of growing majority view on this issue.[164]

In *In re Inyard*, the court was faced with the issue of whether to grant a hardship discharge to debtor after the Trustee contended that hardship discharges may not be granted to deceased debtors.[165] The court held that "neither the text of § 1328(b) nor Rule 2016 bar a deceased debtor from receiving a hardship discharge."[166] The court reasoned that because nothing in the Code specifically limits the hardship discharge to living debtors and Rule 1016's language provides a directive for the case to continue, when possible, as if death did not occur, a hardship discharge could be granted.[167] Further, the court noted that the Bankruptcy Reform Act of 1978 made it easier for deceased debtors to receive a hardship discharge.[168]

As such, the court determined that the debtor in *Inyard* was entitled to a hardship discharge.[169] If a court is willing to grant a hardship discharge, however, the court must also consider whether it is in the best interests of the parties to allow the hardship discharge in the case.[170] This analysis includes an examination of the equities and the amount the debtor paid into the plan.[171] Despite the complexities of this area, many courts are now granting hardship

discharges in Chapter 13 cases in which the plan has been completed after a debtor's death after completing this analysis.[172]

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[1] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934); Colleen Militello, *The Deceased Debtor in Bankruptcy*, in 2015 NO. 9 NORTON BANKR. L. ADVISER NL 1. To note, these materials were prepared after reading Ms. Militello's excellent summary of this issue, and draw from her case law and analysis.

[2] *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[3] *In re* Waring, 555 B.R. 754, 759 (Bankr. N.D. Colo. 2016); Militello, *supra* note 1, at 1-2.

[4] Militello, *supra* note 1, at 1-2.

[5] Militello, *supra* note, at 1-2.

[6] *In re* Waring, 555 B.R. 754, 759 (Bankr. N.D. Colo. 2016); Militello, *supra* note 1, at 1-2.

[7] *See* Militello, *supra* note 1, at 1-2.

[8] *See* Militello, *supra* note 1, at 1-2.

[9] Waring, 555 B.R. at 759; Militello, *supra* note 1, at 1-2.

[10] Militello, *supra* note 1, at 1-2.

[11] *See In re* Shorter, 544 B.R. 654, 660 (Bankr. E.D. Ark. 2016).

[12] *Id*. (quoting Bankruptcy Act of 1898, § 8 (repealed 1978)).

[13] *In re* Perkins, 381 B.R. 530, 534 (Bankr. S.D. Ill. 2007) (quoting H.R. REP. NO. 95-595, 95th Cong., 1st Sess., at 367-68 (1977); S. REP. NO. 95-595, 95th Cong., 2nd Sess., at 82-3 (1978); U.S. Cong. & Admin. News 1978, pp. 5963, 6322-24, 5787, 5868-69)).

[14] Shorter, 544 B.R. at 660.

[15] *Id*.; Militello, *supra* note 1, at 1-2.

[16] Militello, *supra* note 1, at 1-2; *see also* Shorter, 544 B.R. at 660.

[17] FED. R. BANK. P. 1016; Militello, *supra* note 1, at 1-2.

[18] Militello, *supra* note 1 at 1-7; *see also In re* Peterson, 897 F. 2d 935, 935 (8th Cir. 1990); *In re* Bauer, 343 B.R. 234, 235 (Bankr. W.D. Mo. 2006); *In re* Fogel, 550 B.R. 532, 533 (Bankr. D. Colo. 2015); *In re* Hancock, 2009 WL 2461167 at *1 (Bankr. N.D. Okla. Aug. 10, 2009); *In re* Inyard, 532 B.R. 364, 364 (Bankr. D. Kan. 2015); *In re* Martinez, 2013 WL 6051203 at *1 (Bankr. W.D. Tex. Nov. 15, 2013); *In re* Perkins, 381 B.R. 530, 531 (Bankr. S.D. Ill. 2007); *In re* Pollard, 2016 WL 6651258 at *1 (Bankr. M.D. N.C. July 8, 2016); *In re* Shorter, 544 B.R. 654, 657 (Bankr. E.D. Ark. 2016); *In re* Terry, 2015 WL 1321486 at *1 (Bankr. E.D. Pa. March 13, 2015); *In re* Waring, 555 B.R. 754, 755 (Bankr. D. Colo. 2016).

[19] *See* Militello, *supra* note 1, at 1-7; *see also In re* Peterson, 897 F. 2d 935, 935 (8th Cir. 1990); *In re* Bauer, 343 B.R. 234, 235 (Bankr. W.D. Mo. 2006); *In re* Fogel, 550 B.R. 532, 533 (Bankr. D. Colo. 2015); *In re* Hancock, 2009 WL 2461167 at *1 (Bankr. N.D. Okla. Aug. 10, 2009); *In re* Inyard, 532 B.R. 364, 364 (Bankr. D. Kan. 2015); *In re* Martinez, 2013 WL 6051203 at *1 (Bankr. W.D. Tex. Nov. 15, 2013); *In re* Perkins, 381 B.R. 530, 531 (Bankr. S.D. Ill. 2007); *In re* Pollard, 2016 WL 6651258 at *1 (Bankr. M.D. N.C. July 8, 2016); *In re* Shorter, 544

B.R. 654, 657 (Bankr. E.D. Ark. 2016); *In re* Terry, 2015 WL 1321486 at *1 (Bankr. E.D. Pa. March 13, 2015); *In re* Waring, 555 B.R. 754, 755 (Bankr. D. Colo. 2016).

[20] *See* Militello, *supra* note 1, at 1-7; *see also In re* Peterson, 897 F. 2d 935, 935 (8th Cir. 1990); *In re* Bauer, 343 B.R. 234, 235 (Bankr. W.D. Mo. 2006); *In re* Fogel, 550 B.R. 532, 533 (Bankr. D. Colo. 2015); *In re* Hancock, 2009 WL 2461167 at *1 (Bankr. N.D. Okla. Aug. 10, 2009); *In re* Inyard, 532 B.R. 364, 364 (Bankr. D. Kan. 2015); *In re* Martinez, 2013 WL 6051203 at *1 (Bankr. W.D. Tex. Nov. 15, 2013); *In re* Perkins, 381 B.R. 530, 531 (Bankr. S.D. Ill. 2007); *In re* Pollard, 2016 WL 6651258 at *1 (Bankr. M.D. N.C. July 8, 2016); *In re* Shorter, 544 B.R. 654, 657 (Bankr. E.D. Ark. 2016); *In re* Terry, 2015 WL 1321486 at *1 (Bankr. E.D. Pa. March 13, 2015); *In re* Waring, 555 B.R. 754, 755 (Bankr. D. Colo. 2016).

[21] Militello, *supra* note 1, at 7 (citing FED. R. BANKR. P. 7025(a)(1); Bankr. E.D. Cal. LBR 1016-1; Bankr. E.D. Mo. LBR 1016; Bankr. E.D. NC. LBR 1016-1; Bankr. D. Nev. LBR 1016; Bankr. E.D. Okla. LBR 1016-1). Federal Rule of Bankruptcy Procedure 7025(a) incorporates Federal Rule of Civil Procedure 25(a), making it possible for a party to substitute a proper party for the debtor if the claim is not extinguished at a debtor's death. FED. R. BANKR. P. 7025(a); FED. R. CIV. P. 25(a). Rule 7025 requires this motion be brought within 90 days after service of notice of a debtor's death. FED. R. BANKR. P. 7025(a); Militello, *supra* note 1 at 7. Rule 7025 is also applicable in contested matters pursuant to Federal Rule of Bankruptcy Procedure 9014(c). FED. R. BANKR. P. 7025(a); FED. R. BANK. P. 9014(c).

[22] Shorter, 544 B.R. at 660; *see also* Militello, *supra* note 1, at 1-2.

[23] Militello, *supra* note 1, at 2.

[24] Shorter, 544 B.R. at 660; *see generally* Militello, *supra* note 1, at 1-7.

[25] Militello, *supra* note 1, at 2. Debtors occasionally die during the pendency of Chapter 11 and 12 proceedings. *See* In re Chester, 61 B.R. 261 (Bankr. D. S.D. 1986); In re Erickson, 183 B.R. 189 (Bankr. D. Minn. 1995). In *In re* Blair, a Chapter 11 case was converted to a Chapter 7 after the death of the debtor. *In re* Blair, 2016 Wl 8608454 at *1 (Bankr. D. Colo. Aug. 24, 2016).

[26] Shorter, 544 B.R. at 660; *see also* Militello, *supra* note 1, at 2.

[27] Militello, *supra* note 1, at 2; *In re* Waring, 555 B.R. 754, 760 (Bankr. D. Colo. 2016).

[28] Waring, 555 B.R. at 760-61; Militello, *supra* note 1, at 2.

[29] *Id*. at 761 (citing Cult Awareness Network, Inc. v Martino (*In re* Cult Awareness Network, Inc.*)*, 151 F. 3d 605, 607 (7th Cir. 1998); *In re* Morreale, 2015 WL 3897796, at *7-8 (Bankr. D. Colo. June 22, 2015)).

[30] *Id.;* Militello, *supra* note 1, at 2.

[31] Militello, *supra* note 1, at 7.

[32] *In re* Pollard, 2016 WL 6651258 at *1 (Bankr. M.D. N.C. July 8, 2016) (citing 11 U.S.C. § 727(a)(11)).

[33] *See id*.; Militello, *supra* note 1, at 7.

[34] Pollard, 2016 WL at *1 (citing FED. R. BANKR. P. 1016); *see also* Militello, *supra* note 1, at 7.

[35] Pollard, 2016 WL at *1 (citing 11 U.S.C. § 109(h)(4)).

[36] 11 U.S.C. § 109(h)(4); *see also* Militello, *supra* note 1, at 7.

[37] Pollard, 2016 WL at *1 (quoting 11 U.S.C. § 109(h)(4)); Militello, *supra* note 1, at 7.

[38] Pollard, 2016 WL at *1.

[39] *Id*.

[40] *Id*. (quoting 11 U.S.C. § 109(h)(4)); (citing *In re* Thomas, 2008 WL 4835911 (Bankr. D. C. Nov. 6, 2008); (*In re* Henderson, 2008 WL 1740529 (Bankr. W.D. Tex. Apr. 9, 2008); *In re* Trembulak, 362 B.R. 205, 207 (Bankr. D.N.J. 2007)).

[41] *Id*. at *1-2.

[42] *See id*. (citing *In re* Thomas, 2008 WL 4835911 (Bankr. D. C. Nov. 6, 2008); (*In re* Henderson, 2008 WL 1740529 (Bankr. W.D. Tex. Apr. 9, 2008); *In re* Trembulak, 362 B.R. 205, 207 (Bankr. D.N.J. 2007)); Militello, *supra* note 1, at 7.

[43] FED. R. BANK. P. 1016; Militello, *supra* note 1, at 7.

[44] Militello, *supra* note 1, at 2 (quoting 11 U.S.C. § 541(a); 11 U.S.C. § 541(a)(5)).

[45] Militello, *supra* note 1, at 2.

[46] *In re* Bauer, 343 B.R. 234, 237-38 (Bankr. W.D. Mo. 2006).

[47] *Id*. at 235.

[48] *Id*.

[49] *Id*.

[50] *Id*.

[51] *Id*. (quoting 11 U.S.C. § 305)).

[52] *Id*. at 236.

[53] *Id*. at 237; *see also* Militello, *supra* note 1, at 2-3.

[54] Bauer, 343 B.R. at 237-38 (quoting 11 U.S.C. § 541(a)(5)(C)).

[55] *Id*. at 237-38.

[56] *Id*.

[57] *See id*.

[58] *See id*.

[59] *In re* Peterson, 897 F. 2d 935, 937 (8th Cir. 1990); Militello, *supra* note 1, at 2-3.

[60] Peterson, 897 F. 2d at 937; Militello, *supra* note 1, at 2-3.

[61] Peterson, 897 F. 2d at 937; Militello, *supra* note 1, at 2-3.

[62] Peterson, 897 F. 2d at 935; Militello, *supra* note 1, at 2-3.

[63] Peterson, 897 F. 2d at 935; Militello, *supra* note 1, at 2-3.

[64] Peterson, 897 F. 2d at 937; Militello, *supra* note 1, at 2-3.

[65] Peterson, 897 F. 2d at 937.

[66] *Id*. (citing *In re* Friedman, 38 B.R. 275, 276-77 (Bankr. E.D. Pa. 1984); *In re* Rivera, 5 B.R. 313, 315-16 (Bankr. M.D. Fla. 1980)); Militello, *supra* note 1, at 2-3.

[67] Peterson, 897 F. 2d at 938; Militello, *supra* note 1, at 2-3.

[68] Peterson, 897 F. 2d at 938 (citing 11 U.S.C. § 522(b)(2)(A)); Militello, *supra* note 1, at 2.

[69] *In re* Hancock, 2009 WL 2461167 at *1 (Bankr. N.D. Okla. Aug. 10, 2009).

[70] *See* Militello, *supra* note 1, at 2-3.

[71] Hancock, 2009 WL at *3, fn 3.

[72] *Id*.

[73] *Id*. at *1-3.

[74] *Id*. at *1.

[75] *Id*.

[76] *Id*.

[77] *Id*.

[78] *Id*. at *3, fn 3 (Bankr. N.D. Okla. Aug. 10, 2009) (citing 11 U.S.C. § 109(a); 11 U.S.C. § 101(41); *In re* Spiser, 232 B.R. 669, 673 (Bankr. N.D. Tex. 1999); *In re* Jarrett, 19 B.R. 413, 414 (Bankr. M.D. N.C. 1982); Goerg v. Parungo (*In re* Goerg), 844 F. 2d 1562, 1566 (11th Cir. 1988); *In re* Roberts, 2005 B.R. 3108224 (Bankr. D. Md. 2005); *In re* Whiteside, 64 B.R. 99, 100-01 (Bankr. E.D. Cal. 1986); *In re* Patterson, 64 B.R. 807 (Bankr. W.D. Tex. 1986)).

[79] *Id*.

[80] *Id*. at *3 (citing FED. R. BANKR. P. 1016).

[81] *Id*.

[82] *Id*.

[83] *Id*.

[84] *Id*.

[85] *Id*.

[86] *See In re* Waring, 555 B.R. 754, 760-61 (Bankr. D. Colo. 2016); FED. R. BANKR. P. 1016; Militello, *supra* note 1, at 3.

[87] FED. R. BANKR. P. 1016.

[88] Waring, 555 B.R. at 760; Militello, *supra* note 1, at 3.

[89] Waring, 555 B.R. at 755; Militello, *supra* note 1, at 2.

[90] Waring, 555 B.R. at 761.

[91] *Id.* ; *see also* Militello, *supra* note 1, at 3.

[92] Waring, 555 B.R. at 761 (quoting FED. R. BANKR. P. 1016 Advisory Committee Note (1983)); *see also* Militello, *supra* note 1, at 3.

[93] *See* Militello, *supra* note 1, at 3-7.

[94] Militello, *supra* note 1, at 3-7.

[95] Militello, *supra* note 1, at 3-7.

[96] Militello, *supra* note 1, at 3-7.

[97] Militello, *supra* note 1, at 3-7.

[98]*See* Militello, *supra* note 1, at 3-7.

[99] Waring, 555 B.R. at 761; *see also* Militello, *supra* note 1, at 3-4.

[100] Waring, 555 B.R. at 755; Militello, *supra* note 1, at 3-4.

[101] Waring, 555 B.R. at 757; Militello, *supra* note 1, at 3-4.

[102] Waring, 555 B.R. at 755.

[103] *Id.* at 766.

[104] *Id.* at 755.

[105] *Id.* at 756.

[106] *Id.* at 757.

[107] *Id.*

[108] *Id.* at 756, 764.

[109] *Id.* at 764-65; Militello, *supra* note 1, at 3.

[110] Waring, 555 B.R. at 765; Militello, *supra* note 1, at 3.

[111] Waring, 555 B.R. at 765.

[112] *Id.* (citing *In re* Fogel III, 550 B.R. 532 (D. Colo. 2015); *In re* Inyard, 532 B.R. 364 (Bankr. D. Kan. 2016); *In re* Hoover, 2015 WL 1407241 (Bankr. D. Cal. March 24, 2015); *In re* Kosinski, 2015 WL 1177691 (Bankr. N.D. Ill. March 5, 2015); *In re* Ferguson, 2015 WL 4131596 (Bankr. W.D. Tex. Feb. 24, 2015)).

[113] *Id.* at 765.

[114] *Id.* at 766.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.* at 764.

[119] *See id*. at 755; *In re* Martinez, 2013 WL 6051203 at *1 (Bankr. W.D. Tex. Nov. 15, 2013).

[120] Martinez, 2013 WL *1.

[121] *Id*.

[122] *Id*. (citing *In re* Ellsworth, 455 B.R. 904, 916 (9th Cir. BAP 2011)).

[123] *Id*.

[124] *Id*.; Waring, 555 B.R. at 755; Militello, *supra* note 1, at 3.

[125] Militello, *supra* note 1, at 4; *In re* Terry, 2015 WL 1321486 at *4 (Bankr. E.D. Pa. March 13, 2015); *see also* Hon. William L. Norton, Jr. & William L. Norton, III, *The Deceased Debtor: Rule 1016's Application to the Chapter 13 Case*, 7 NORTON BANKR. L. & PRAC. 3D § 153:8.

[126] Terry, 2015 WL at *4; Militello, *supra* note 1, at 4.

[127] Terry, 2015 WL at *4; Militello, *supra* note 1, at 4.

[128] Terry, 2015 WL at *4; Militello, *supra* note 1, at 4.

[129] Militello, *supra* note 1, at 4; *see also* Norton, *supra* note 125.

[130] Militello, *supra* note 1, at 5.

[131] *In re* Fogel, 550 B.R. 532, 533 (Bankr. D. Colo. 2015); Militello, *supra* note 1, at 4.

[132] Militello, *supra* note 1, at 4-5.

[133] Fogel, 550 B.R. at 533-34; Militello, *supra* note 1, at 4.

[134] Fogel, 550 B.R. at 533.

[135] *Id*. at 534.

[136] *Id*.

[137] *Id*.

[138] *Id*. at 535.

[139] *Id.* at 534.

[140] *Id*. at 535.

[141] *Id*. (quoting FED. R. BANKR. P. 1016).

[142] *Id*. at 535.

[143] *Id*.

[144] *Id*. (citing *In re Terry*, 2015 WL 1321486 at *4) (Bankr. E.D. Pa. March 13, 2015)).

[145] Fogel, 550 B.R. at 535-36 (quoting *In re* Kosinski, 2015 WL 1177691 at *3 (Bankr. N.D. Ill. March 5, 2015)).

[146] *Id*. at 536 (Bankr. D. Colo. 2015) (citing *In re* Kosinski, 2015 WL 1177691 at *3 (Bankr. N.D. Ill. March 5, 2015); FED. R. BANKR. P. 1016).

[147] Fogel, 550 B.R. at 536 (citing 11 U.S.C. § 109(h)(4)).

[148] *Id*. at 536.

[149] *See In re* Inyard, 532 B.R. 364, 368 (Bankr. D. Kan. 2015); *In re* Kosinski, 2015 WL 1177691 at *3 (Bankr. N.D. Ill. March 5, 2015); *In re* Perkins, 381 B.R. 530, 537 (Bankr. S.D. Ill. 2007)); Militello, *supra* note 1, at 4-5.

[150] *In re* Shorter, 544 B.R. 654, 662 (Bankr. E.D. Ark. 2015). To note, the debtor's husband was held to be the appropriate personal representative in this case. *Id*.

[151] *See* Inyard, 532 B.R. at 368; *Kosinski*, 2015 WL at *3; Perkins, 381 B.R. at 537; Militello, *supra* note 1, at 4-5.

[152] *See* Inyard, 532 B.R. at 368; *Kosinski*, 2015 WL at *3; Perkins, 381 B.R. at 537; Militello, *supra* note 1, at 4-5.

[153] *See* Perkins, 381 B.R. 530, 531-37 (Bankr. S.D. Ill. 2007); Militello, *supra* note 1, at 5.

[154] Perkins, 381 B.R. at 532.

[155] *Id*.

[156] *Id*.; *see also* Militello, *supra* note 1, at 5.

[157] Perkins, 381 B.R at 533; *see also* Militello, *supra* note 1, at 5.

[158] Perkins, 381 B.R 536; *see also* Militello, *supra* note 1, at 5.

[159] *In re* Fuller, 2010 WL 1463150 at *1-2 (Bankr. D. Colo. March 11, 2010); *see also* Militello, *supra* note 1, at 5.

[160] Perkins, 381 B.R. at 533; Fuller, 2010 WL at *1-2; *see also* Militello, *supra* note 1, at 5.

[161] Militello, *supra* note 1, at 5; Inyard, 532 B.R. at 371-73; Shorter, 544 B.R. at 670.

[162] Inyard, 532 B.R. at 366.

[163] *Id.* (quoting 11 U.S.C. § 1328(b)); *see also* Militello, *supra* note 1, at 5-7.

[164] Inyard, 532 B.R at 366; Militello, *supra* note 1, at 5-7.

[165] Inyard, 532 B.R at 368.

[166] *Id*. at 370.

[167] *Id*.

[168] *Id*. (citing 1938 Chandler Act (repealed 1978)).

[169] *Id*. at 370-71.

[170] *Id*. at 371.

[171] *Id*. at 371-73.

[172] *Id*.; Shorter, 544 B.R. at 670; Militello, *supra* note 1, at 5-7.

ABI Midwestern Bankruptcy Institute
Bankruptcy Law Round-Up

October 27, 2016
Hon. Janice Miller Karlin[1]

TOPIC: When are settlement proceeds, received after discharge, property of the estate?

FACTS: After discharge and closing of the bankruptcy case, a debtor reaches a settlement agreement with a medical device manufacture as part of a class action product liability suit. Debtor claims her discovery of the potential cause of action occurred post-discharge, but the medical procedure in which the device was implanted was pre-discharge. After the case is reopened, the Trustee moves for turnover of the settlement proceeds, arguing that they are property of the estate under 11 U.S.C. § 541(a)(1).

Questions

1. **Are settlement proceeds property of the estate when the discovery of the cause of action was post-discharge, but the action giving rise to the claim was pre-discharge?**
2. **Does the answer change depending on whether the case is a Chapter 7 or 13?**
3. **Does the answer change depending on what state the cause of action arises in?**
4. **Is there a conflict between the Supreme Court's rulings in *Segal* (property interests that accrue post-petition belong to the bankruptcy estate if they are sufficiently rooted in the pre-bankruptcy past) and *Butner* (property interests are created by state law, absent Congressional preemption)?**

Pertinent Statutes

11 U.S.C. § 541(a)(1): Property of the estate includes "all legal or equitable interests of the debtor *in property* as of the commencement of the case."

11 U.S.C. § 1306(a)(1): Property of the estate includes "all property of the kind specified in [§ 541] that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted".

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[1] With thanks to law clerk, Jon Ruhlen.

11 U.S.C. § 101(5): "The term 'claim' means–

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

K.S.A. § 60-513(b): two-year statute of limitations for most torts, but cause of injury is tolled when fact of injury is not immediately ascertainable; cause of action does not accrue "until the fact of injury becomes reasonably ascertainable to the injured party."

Caselaw

In re Purcell, No. 08-40224, 2017 WL 3081643 (Bankr. D. Kan. July 19, 2017) (Chapter 13 debtor reached settlement agreement with manufacturer of defective transvaginal mesh more than five years after her case was closed. Medical procedure to implant the device occurred five days after discharge but two months before case was administratively closed, but discovery of injury was well after case was closed. Applicable Kansas law dictates that property interest in cause of action does not arise until ascertainable (the discovery rule), therefore, because property interest did not exist until after case was closed, settlement proceeds were not property of the estate).

Segal v. Rochelle, 382 U.S. 375, 380 (1966) (tax refunds received postpetition for business losses incurred prepetition were property of the estate because they were sufficiently rooted in the prebankruptcy past. *See also* S. Rep. No. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868 (Congress intended to follow the result of *Segal* when defining property of the estate in the 1978 Bankruptcy Code).

Butner v. United States, 440 U.S. 48, 54-55 (1979) (Congress has constitutional authority to establish uniform laws on the subject of bankruptcies, but when Congress has chosen not to define "property" as used in § 541, the question of when an interest in property arises is resolved by reference to state law).

Adams v. American Medical System, Inc., ___ Fed.Appx. ___, 2017 WL 3668930 (10th Cir. Aug. 25, 2017) (dismissing products liability action against manufacturer of pelvic mesh sling, finding the Utah Code § 78B-6-706 statute of limitations had run because plaintiff discovered or in the exercise of due diligence should have discovered "her harm and its cause" more than two years before she brought suit).

Combs v. The Cordish Companies, Inc., ___ F.3d ___, 2017 WL 2856624 (8th Cir., July 5, 2017) (African-American male patrons' cause of action against

entertainment district for race discrimination did not arise until after Chapter 7 petition was filed and therefore plaintiffs were not judicially estopped from bringing 42 U.S.C. § 1981 action against entertainment district).

Parks v. Dittmar (In re Dittmar), 618 F.3d 1199, 1204-07 (10th Cir. 2010) (synthesizing the *Segal* and *Butner* tests, the Tenth Circuit established a three part test to determine whether Chapter 7 debtors' employee stock appreciation rights were property of the estate: (1) whether the debtors had a property interest under state law; (2) whether that interest existed prepetition; and (3) whether that interest was property of the estate under § 541).

In re Smith, 293 B.R. 786, 787-89 (Bankr. D. Kan. 2003) (although Chapter 7 debtor took later-banned weight loss drug Fen-Phen before her bankruptcy, discovery of her cause of action against manufacturer was post-discharge and thus based on discovery rule, settlement proceeds were not property of the estate).

Watson v. Parker (In re Parker), 313 F.3d 1267 (10th Cir. 2002) (creditor's malpractice claim against debtor was property of the estate despite not arising until after debtor's discharge; court found that the Tenth Circuit follows the conduct theory as to when a cause of action arises with respect to a claim against the estate).

In re Forbes, 215 B.R. 183, 190 (B.A.P. 8th Cir. 1997) (Chapter 13 debtor's settlement proceeds from post-petition cause of action was not property of the estate because it did not exist at the time of the petition date and therefore was not part of § 1325(a)(4) liquidation analysis).

Cases Outside 10th and 8th Circuits

In re Ross, 548 B.R. 632, 638-40 (Banrk. E.D.N.Y. 2016) (Because Chapter 7 debtor's cause of action against transvaginal mesh manufacturer did not exist at commencement of case because debtor had not discovered potential damage, it was not property of the estate. The district court affirmed, *Mendelsohn v. Ross*, No. 16-CV-2071, 2017 WL 1900288 (E.D.N.Y. May 9, 2017), but based its decision on *Segal* and found that the cause of action was not rooted in the pre-bankruptcy past and therefore not property of the estate).

In re Richards, 249 B.R. 859, 861-62 (Bankr. E.D. Mich. 2000) (claim for asbestos injuries was property of the estate because exposure was prepetition, even though ability to sue, under Michigan law, arose postpetition). *See also Nelson v. A-C Product Liability Trust*, 549 B.R. 87 (E.D. Pa. 2016).

In re Webb, 484 B.R. 501 (Bankr. M.D. Ga. 2012) (debtor's heart problems which were diagnosed prepetition were sufficiently rooted in the prebankruptcy past to make proceeds from a class action settlement with the manufacturer of a heart medication property of the bankruptcy estate, despite fact debtor did not discover the cause of the heart problems until after discharge, despite Georgia law following the discovery rule in tort cases).

Child Support Conundrums in Chapter 13 Bankruptcy

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I. Introduction

Bankruptcy is not a haven for divorced or divorcing individuals seeking to avoid domestic support financial obligations. For reasons of public policy, Congress has decided that child support debt is too important to be wiped out by bankruptcy. Section 523(a)(5) of the bankruptcy code provides that a discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual from any debt - for a domestic support obligation. ***See*** 11 U.S.C. § 523(a)(5). Child support falls within the bankruptcy term (domestic support obligation," defined at 11 U.S.C. § 101(14A):

> (14A) The term "domestic support obligation" means a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law notwithstanding any other provision of this title, that is –
>
> (A) owed to or recoverable by –
>
> (i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or
>
> (ii) a governmental unit;
>
> (B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly so designated;

(C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of -

(i) a separation agreement, divorce decree, or property settlement agreement;

(ii) an order of a court of record; or

(iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and

(D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative for the purpose of collecting the debt.

If a debtor gets behind on court-ordered support payments, state laws provide the ex-spouse and the support enforcement agencies much more powerful collection tools to use against the delinquent debtor. For example, a debtor's tax refund can be intercepted. His or her driver's license can be suspended, including a commercial license that is required for a job. Many states also allow the suspension of occupational, professional, and recreational licenses. Needless to say, the consequences can be catastrophic.

Attorneys who represent debtors, creditors, or trustees face intricate and difficult problems dealing with child support recipients or debtors who are delinquent in paying child support. BAPCPA added restraints on what can and cannot be done. ***See Appendix A*** for an enumeration of the various statutes that must be considered in drafting Chapter 13 plans dealing with delinquent child support. Filing a Chapter 7 does not help a delinquent child support debtor

against these collection methods. However, a Chapter 13 petition can provide a breathing period in which to sort out issues without the additional pressure of creditor collection actions. The following potpourri of sample factual situations illustrates some of the extraordinary challenges that happen when debtors cannot make their child support payments.[1]

II. Hypotheticals in Chapter 13 Cases

A. Patricia Penniless Owes $50,000 To Her Former Spouse

Patricia Penniless is anxiety-ridden and terribly confused when she arrives for her appointment at the office of Marilyn Miracle Worker. She has other debts but is most concerned because she says that she owes $50,000 to her former spouse. Patricia Penniless cannot clearly tell you how much of this amount is for child support and how much is a property settlement. Will Marilyn Miracle Worker be able to help Patricia Penniless?

B. Walter Worker Owes $5,000 In Past Due Child Support To The State

Walter Worker is a forty-five year old over-the-road truck driver who has trouble arranging and keeping appointments. He has a lot of other debts, and tells his new attorney, Tom Terrific, that he owes about $5,000 in past due child support to the State Child Support Enforcement Agency. Walter Worker also states that his ex-wife is not involved in the collection process. He needs to pay his house payments and his truck payments but he does not think that he can also afford to pay the $5,000 in full under a Chapter 13 plan.

C. Debtor Dave Loses Job After Filing

Debtor Dave is divorced and has two school-age children who reside with their mother in another state. He seeks out Competent Carl, a local bankruptcy attorney,

[1] The Chapter 13 Trustee gratefully acknowledges the contribution Thomas P. Kenny, Counsel to Kathleen Laughlin, Chapter 13 Trustee District of Nebraska, made to a portion of the written materials for the presentation.

because he got behind on his new car payments and needs his car to get back and forth to work at the manufacturing plant where he has a good paying job. The bank is threatening to take his new car away. Debtor Dave says that he owes child support for his two young children, but that he is current on making his child support payments. Competent Carl files a Chapter 13 bankruptcy petition for Debtor Dave but before the plan gets confirmed, the debtor informs his attorney that he lost his job right after the meeting of creditors and was not able to pay his child support for several months. Debtor Dave obtained new employment at another plant but cannot catch up on his regular child support payments. Can Competent Carl salvage this case?

D. Will Notpay And The Erroneous Filings

Will Notpay and his second wife are below-median income debtors who have been in a confirmed Chapter 13 plan for approximately eighteen months. The State Child Support Center filed a proof of claim for his first wife for child support arrears of $14,900.34 plus $406.66 in interest totaling $15,807.00. However, the State Child Support Center has not filed any other pleadings in the case or participated in any hearings. Will Notpay is supposed to pay $500 in child support per month and his attorney, Teresa Trouble, filed an original and 3 amended Schedule I's showing the $500 per month being deducted from his pay. As required for confirmation, Will Notpay also filed a Certification of Debtor in Support of Confirmation in which he declared under penalty of perjury as follows: I have paid all amounts that first became due and payable after the filing of this bankruptcy, which I am required to pay under a domestic support obligation [as defined in 11 U.S.C. § 101(14A) required by a judicial or administrative order, or by statute. There is a wage deduction order in the case, and the Chapter 13 debtors have always been current on their payments to the Chapter 13 Trustee. Besides child support and some

other debts, Will Notpay and his wife have been paying for two cars through the Chapter 13 Trustee's office.

Now one of the cars needs significant repairs and the debtors want to purchase a newer (used not luxury) vehicle, pay for it directly, and lower their payments to the Chapter 13 Trustee. Teresa Trouble filed an amended plan which reduced the amount of their plan payment and another amended Schedule I which indicated the debtor's employer was withholding $500 per month for his child support. The attorney for the Chapter 13 Trustee objected to the amended plan and requested verbally the most recent monthly pay stubs. Teresa Trouble did not provide the most recent monthly pay stubs, and the Chapter 13 Trustee thereafter filed a motion requesting the same information. When the Chapter 13 trustee was finally presented with the most recent pay stubs, the documents showed that Will Notpay had changed employers, increased his earnings, and that the $500 per month child support payment was not being deducted from his wages.

Counsel for the Chapter 13 Trustee then requested verbally and then again filed a motion for the debtor to provide a payment history for his child support. Teresa Trouble did not produce the payment history but left a telephone message after hours on the Chapter 13 Trustee's answering machine that the debtor had learned that he was delinquent $16,000 in child support and his employer had failed to withhold for the child support. When Teresa Trouble filed a Certificate of Service with the Court stating…."Debtor has been unable to obtain any documents from the State Child Support Center, " the Chapter 13 Trustee contacted the Child Support Center who prompted provided the Chapter 13 Trustee with a copy of the payment history. The documents obtained by the Trustee show that Will Notpay has not paid any child support since before he filed the case. Now what should Will Notpay's counsel, Teresa Trouble, do?

E. Derek Done and the Interest on Child Support

Derek Done and his second wife filed a Chapter 13 bankruptcy in 2011. They were an above median income couple who had lots of debts including the past due child support Derek Done owed to his first wife. Their attorney, Oliver Ouch, designed a five-year plan which did not specify how the post-petition interest on the child supports arrears would be handled. Mr. & Mrs. Derek Done did everything their attorney, Oliver Ouch, told them to do. They successfully completed payments under the Chapter 13 plan which paid off all of his child support arrearages to his first wife, and the Dones received a Chapter 13 discharge in 2016. Oliver Ouch considered this a real success story.

In early 2017 the State Child Support Collection Agency sent a wage assignment to Derek Done's employer to collect the interest that had accrued during the five years the debtor was in bankruptcy. Derek Done called and left an angry voice mail on Oliver Ouch's answering machine. What should Oliver Ouch tell Derek Done now?

F. Debtor Dan and the Zealous Child Support Enforcement Collector, Part 1

Debtor Dan is a forty-three year old podiatrist who got divorced six years ago. He was obligated to pay his ex-wife $900 per month for his ten-year-old son. Five years ago, after working as an employee for ten years, he decided to start his own podiatry office. He put a great deal of effort into creating a good business plan and then worked very hard at executing it. However, Dan Debtor discovered that it takes time and it is very hard to build a business.

Throughout most of these difficult five years he still found a way to pay his child support. But there were several periods of two or three months when there was absolutely no money to pay it. During these times his ex-wife had been understanding of the predicament. Her income

had increased, and she knew that Debtor Dan was genuinely doing his very best. She also believed that Debtor Dan's business would ultimately be profitable. Debtor Dan did not go to court to try to reduce the monthly support amount to better reflect their changed incomes. Then, a year ago, after a period of four consecutive missed support payments, Debtor Dan and his ex-wife had argument. Thereafter, his ex-wife contacted the state child support enforcement agency.

Child Support Enforcement authorities required Debtor Dan to make his regular monthly payments through the agency, which he did diligently. As for the arrearage, the Agency recently garnished his business checking account, causing havoc there. He still owes $7,500. Now the agency is threatening to suspend both his driver's license and his podiatrist license. These actions would put him out of business. Given the financial struggles of his last five years, Dan Debtor has lots of other debts and absolutely no way of coming up with the $7,892.00.

Debtor Dan made an appointment and sought the service of a competent bankruptcy attorney, Sam Savior, who carefully reviewed all of the possible options. What should Sam Savior advise Debtor Dan to do?

1) Do nothing. These things will work themselves out.
2) File a Chapter 7 bankruptcy
3) File a Chapter 13 bankruptcy and wait for the Child Support Enforcement Agency to file a proof of claim so that the amounts owed will be certain and definite.
4) File a Chapter 13 bankruptcy and the debtor should file a proof of claim on behalf of the debtor's ex-wife based upon the amounts currently known.

G. <u>Debtor Dan and the Zealous Child Support Enforcement Collector, Part 2</u>

Assume that Debtor Dan followed the advice of his counsel and he filed a Chapter 13 case. His debts included a priority claim for $7,892.00 in past-due child support. Sam Savior, Dan's attorney, carefully monitored which creditors had filed proofs of claims in the case. When

he discovered that the Child Support Enforcement Agency had not filed a proof of claim for delinquent child support, Sam Savior promptly filed a proof of claim on behalf of the debtor's former wife for that debt. The Chapter 13 plan, which was confirmed without any objections, proposed to pay $154.00 per month on that arrearage. Those payments have been, and are being, made promptly.

After the Chapter 13 case was confirmed, the Child Support Enforcement agency sent Debtor Dan two letters, in April and June, notifying him that he was approximately $8,000.00 behind on his child support. The first letter warned him that if he did not reduce the balance due to less than $500.00, he would be reported to the credit bureaus. Debtor Dan promptly brought this letter to Sam Savior's attention. His attorney contacted a local child support enforcement staff member to request the cessation of such correspondence because Debtor Dan was paying the debt through the Chapter 13 bankruptcy plan.

The local child support enforcement staff member responded to Sam Savior that "being in an active bankruptcy does not prohibit [us] from submitting past due payers to consumer credit reporting agencies." Child Support Enforcement then sent the second letter to Debtor Dan conveying their intention to recoup the amount due via interception of monies owed him by the state and federal governments, including tax refunds. Debtor Dan brought the second letter to the attention of his counsel.

How should Sam Savior proceed? Does the automatic stay of 11 U.S.C. § 362 prohibit the action taken by the state Child Support Enforcement agency?

H. Debtor Darren and the Zealous Child Support Enforcement Collector, Part 3

Debtor Darren filed a Chapter 13 bankruptcy to handle his child support arrearages approximately 3 months ago. Debtor Darren informs his attorney that his huge support arrearage payment continues to be coming out of his pay check and that the child support enforcement

agency has now grabbed his tax refund. Debtor Darren's Chapter 13 payment combined with the state's garnishment takes 90% of his take home pay. He needs help. One of these payments has to stop.

III. Takeaways for Discussion

A. Patricia Penniless Owes $50,000 To Her Former Spouse

Domestic support obligations such as alimony and child support receive special treatment in bankruptcy. If Patricia Penniless owes child support, she cannot discharge or eliminate her obligation by filing a Chapter 7 or a Chapter 13.

Filing for bankruptcy also does not change a debtor's obligation to pay child support to the child support recipient. Whether a debtor files a Chapter 7 or a Chapter 13 bankruptcy, Patricia Penniless must continue to make her ongoing child support payments to the child support recipient as the payments are due. Before she can obtain a confirmable plan, Patricia Penniless must certify to the court that she is current on all of her domestic support obligations. Additionally, before she can receive a Chapter 13 discharge, Patricia Penniless must certify to the court that she is current on all of her domestic support obligations.

Moreover, child support is a priority debt in bankruptcy. If Patricia Penniless files a Chapter 13 bankruptcy, she must pay off all of her priority obligations in full through her Chapter 13 plan. There are two exceptions to this rule. The plan could be confirmed if the child support recipient has agreed to a different treatment of the claim (it would be a good practice to require the recipient to put that agreement in a writing filed with the Court), or if the claim were determined to be of a type assigned to or recoverable by a governmental unit as discussed in 11 U.S.C. § 507(a)(1)(B) and 11 U.S.C. § 1322(a)(4).

If Patricia Penniless owes a property settlement, she can discharge and can eliminate this obligation by filing a Chapter 13 bankruptcy petition. However, property settlements are not

dischargeable in Chapter 7. In Chapter 13 property settlement and other (non-support debt) can be discharged in a completed Chapter 13 case. Such a property settlement debt is excepted from discharge now only when the debtor is unable to complete plan payments and obtains a hardship discharge pursuant to 11 U.S.C. § 1328(b). Notice that the Chapter 13 discharge provision, 11 U.S.C. § 1328(a)(2) does not include § 523(a)(15) in the exception to discharge provisions.

To help Patricia Penniless, debtor's counsel must determine the nature and extent of each obligation, and get the child support paid. Generally, DSO's are "in the nature of support."[2] A debt is in the nature of support and consequently non-dischargeable under §523(a)(5) only when it is "in substance support." The court must determine if the obligation is "actually in the nature of alimony, maintenance or support" in order to determine if the obligation is a domestic support obligation for all purposes under the Bankruptcy Code. Federal law is used to make the determination, and it is measured at the time of the divorce. No one factor may be controlling. Generally, if the obligation is essential to enable a party to maintain basic necessities, the payment of the debt is in the nature of support. Another way to look at the matter is that support usually looks forward, and nonsupport usually splits items and looks backwards.

If Patricia Penniless cannot afford the plan payments because she owes too much in child support to the custodial parent, debtor's counsel will have to try to negotiate a voluntary alternative treatment, which would usually involve setting up a longer repayment plan or leaving an existing payment plan in effect to allow Patricia Penniless to deal with her other pressing debt issues.

[2] It should be noted that sometimes, the question of whether if it's really a domestic support obligation can be important; though it is for purposes of this paper, beyond the scope of our discussion.

B. Walter Worker Owes $5,000 In Past Due Child Support To The State

Attorney Tom Terrific must first ascertain whether Walter Worker's child support claim falls within the statutory framework for assigned priority child support claims. Section 1322(a)(2) of the bankruptcy code generally requires that a Chapter 13 debtor pay in full all § 507 priority claims. However, § 1322(a)(4) provides an exception to the full payment of priority claims requirement and allows less than full payment of § 507(a)(1)(B) priority claims but only if the plan requires the debtor to pay all of his projected disposable income into the plan for a five year period. Domestic support obligations assigned to governmental units have the second highest priority of any type of debt in bankruptcy pursuant to 11 U.S.C. § 507(a)(1)(B). Reading these statutory sections together means that if there are any funds available in Walter Worker's Chapter 13 case, the governmental assigned child support will be one of the first creditors to receive payment and certainly before any general unsecured creditors. Walter Worker's child support debt will not be discharged but his other debts could be discharged, the assigned priority child support debt could get paid down before other unsecured creditors, and Walter Worker will be in a better position to make payments on the child support when the plan has been completed.

C. Debtor Dave Loses Job After Filing

A Chapter 13 plan cannot be confirmed unless "the debtor has paid all amounts that are required to be paid under a domestic support obligation, and that first become payable after the date of the filing of the petition if the debtor is required by a judicial or administrative order, or by statute, to pay such domestic support obligation…." ***See*** 11 U.S.C. § 1325(a)(8). Before he can obtain a confirmable plan, Debtor Dave must also certify to the court that he is current on all of his domestic support obligations. Additionally, a debtor "who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation" cannot receive a discharge until he "certifies that all amounts payable under such order or such statute that are due

on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid,…" ***See*** 11 U.S.C. § 1328(a).

Debtor Dave is between the rock and the hard place. Either he can get caught up, or he can't. If Debtor Dave cannot get caught up, dismissal appears to be the only option. If he falls behind before confirmation, Debtor Dave cannot get a plan confirmed. If Debtor Dave has a confirmed plan and gets behind in child support payments, he will not be able to get a discharge.

D. Will Notpay And The Erroneous Filings

Questions of ethics exist here. Because ethical rules vary from state to state, Teresa Trouble needs to immediately consult the ethical rules applicable in her state.

It is difficult to believe that debtor's counsel did not realize that her client, Will Notpay, was not paying his child support if she had received and carefully reviewed his pay stubs at the beginning of the case before it was filed. It is also not credible that Teresa Trouble is blaming the employer for the debtor being delinquent, and that the debtor did not review his own pay stubs and ascertain that the payments were not coming out.

It would seem that Teresa Trouble should do everything in her power to get the client to correct any misstatements on the court records. She should also obtain his permission to withdraw or revise the certifications, and get his permission to have confirmation reconsidered. If the client refuses, Teresa Trouble has to decide if she is going to correct the problem by disclosing the misstatement to the Court. Teresa Trouble has a duty to keep information confidential. She may be able to disclose confidential information in order to prevent a crime or to comply with other applicable laws or court orders. Be aware that you may have to disclose the misstatement in order to maintain candor toward the Court.

E. Derek Done And The Interest on Child Support

Generally, "interest on nondischargeable child support obligations, like interest on nondischargeable tax debt, continues to accrue after a Chapter 13 petition is filed and is not dischargeable." The State Child Support Enforcement Agency could collect against the debtor after the debtor's bankruptcy was concluded. ***See Foster v. Bradbury (In Re Foster)***, 319 F.3d 495 (9th Cir. 2003).

Debtor's counsel needs to be aware that the non-dischargeable child support claimant could come after the debtor for interest after discharge on non-dischargeable child supports claims even if they were paid in full under the plan. Oliver Ouch should have advised his client Derek Done accordingly and planned for this contingency.

Sometimes debtor's counsel will draft a plan provision adding interest in the plan for priority tax claims or other non-dischargeable claims but this strategy can be problematic. Although no other party in interest may object to debtor's attorneys adding interest, the practice is NOT allowed unless the plan pays in full all claims. Specifically, 11 U.S.C. 1322(b)(10) provides….:"for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are non-dischargeable under section 1328(a), except that such interest may be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims." ***See In re Jordahl***, 539 B.R. 567 (8th Cir. BAP 2015) where the 8th Circuit B.A.P. held that direct pay was impermissibly discriminatory. Honorable Barry Schermer, U.S. Bankruptcy Court E.D. Missouri was the author with Honorable Thomas Saladino, U.S. Bankruptcy Court District of Nebraska and Honorable Charles L. Nail, Jr., U.S. Bankruptcy Court District of South Dakota on the panel.

The same concerns previously expressed by debtors' counsel above were discussed in Nebraska when the Bankruptcy Practice Subcommittee on a Chapter 13 Plan met recently. I did a little research and came up with a "debtor-friendly" opinion on the issue. See attached ***In Re Lightfoot***, No. 13-32970-H4, 2015 WL3956211 (Bankr. S.D. Texas 2015) June 22, 2015 (Bohm) The Bankruptcy Court held that post-petition interest is part of a domestic support claim under § 101(14A) as amended by BAPCPA; plan not only can but must pay post-petition interest notwithstanding that other unsecured creditors will not be paid in full under 11 U.S.C. § 1322(b)(10).

As far as I know, there is no contrary opinion here so arguably the debtor could provide for child support with interest to be paid in full under the plan even though other unsecured creditors will be paid less. After December 1, 2017, another option might be afforded by the fact that all bankruptcy courts will have to use either the National Plan or a plan that meets the mandatory requirements of plans in opt-out courts. If the debtor chooses to use non-standard language, the debtor could provide for this result in a plan's non-uniform section.

F. Debtor Dan and the Zealous Child Support Enforcement Collector, Part 1

Debtor's counsel, Sam Savior, must do something because Child Support Enforcement Collector has the power and could follow through on its threaten to suspend Debtor Dan's driver's license and podiatrist license.

Filing a Chapter 7 bankruptcy may not be the better option here. Back child support is still a priority debt and nondischargeable. In fact, domestic support obligations have the highest priority of any type of debt in bankruptcy. This means that if there are any proceeds to distribute in the case, the child support recipient will be the first creditor to receive payment. If there are no assets to distribute, the child support recipient will not receive anything from the Chapter 7

debtor. The Chapter 7 discharge will not eliminate the debtor's outstanding child support arrears and may not provide much of a breathing space to reorganize as the case may be over very soon.

Keep in mind that to get paid in a Chapter 13 bankruptcy, the debtor, the trustee, the child support recipient, or the appropriate state child support agency must file a proof of claim with the court, including the supporting documentation to show the amount of back child support owed. Filing a Chapter 13 bankruptcy and providing for the child support arrearages to be paid will be futile if there is no proof of claim on file.

When a support arrearage has developed and the debtor's income is limited, making up that arrearage over time through a Chapter 13 plan can be the best alternatives for curing the default especially if the plan is funded by deduction from the debtor's paycheck. It is also good for debtor's counsel to not leave anything to chance; file a proof of claim for the child support if the recipient or child support agency has not filed a proof of claim.

G. Debtor Dan and the Zealous Child Support Enforcement Collector, Part 2

In this case it appears that the state child support agency did violate the automatic stay because the creditor's first letter appears to be an attempt to collect money from the debtor by declaring that if he pays down the past-due amount, the State will not report the account to the credit bureau. It was also a good on the part of the debtor's attorney to file a proof of claim for the State agency. ***See In Matter of Schroeder***, Case No. Bk 08-40711-TLS (Bankr. D. Neb. 10/23/2009). But ***See State of Missouri Dept. of Soc. Serv. v. Spencer***, Case No. 16-3183 (8th Cir. Aug. 22, 2017).

H. Debtor Darren and the Zealous Child Support Enforcement Collector, Part 3

Review the automatic stay provisions regarding child support found at 11 U.S.C. § 362(b)(2)(B),(C), (E), and (F). Filing bankruptcy does not stop (stay) the withholding of

income for the collection of child support. If debtor's counsel cannot convince the person or the child support enforcement agency to voluntarily stop the garnishment, debtor's counsel could propose to lower Debtor Darren's plan payment, at least until the debtor can get a plan confirmed or otherwise request the Court to extend the automatic stay to support payments.

Appendix A

Relevant Statutes Regarding Dealing With Child Support in Chapter 13

11 U.S.C. § 362(b)(2)(C): The automatic stay does not apply with respect to the withholding of income that is property of the estate or property of the debtor for the payment of a domestic support obligation accruing both before or after the filing, so long as such obligations meet the definition of Domestic Support Obligations, even where such obligation has been assigned to a governmental unit.

11 U.S.C. § 362(b)(2)(D): The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—

> (D) of the withholding, suspension, or restriction of a driver's license, a professional or occupational license, or a recreational license, under State law, as specified in section 466(a)(16) of the Social Security Act;

11 U.S.C. § 362(b)(2)(E): The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—

> (E) of the reporting of overdue support owed by a parent to any consumer reporting agency as specified in section 466(a)(7) of the Social Security Act;

11 U.S.C. § 362(b)(2)(F): The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—

(F) of the interception of a tax refund, as specified in sections 464 and 466(a)(3) of the Social Security Act or under an analogous State law;

11 U.S.C. § 507(a)(1): The following expenses and claims have priority in the following order:

(1) First:

(A) Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition in a case under this title, are owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the petition shall be applied and distributed in accordance with applicable nonbankruptcy law.

(B) Subject to claims under subparagraph (A), allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are assigned by a spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative to a governmental unit (unless such obligation is assigned voluntarily by the spouse, former spouse, child, parent, legal guardian, or responsible relative of the child for the purpose of collecting the debt) or are owed directly to or recoverable by a governmental unit under applicable nonbankruptcy law, on the condition that funds received under this paragraph by a governmental unit under this title after the date of the filing of the

petition be applied and distributed in accordance with applicable nonbankruptcy law.

11 U.S.C. § 704(c)(1) and § 1302(d): A Chapter 13 or a Chapter 7 trustee must notify the holder of a support claim of its rights to use the services of a support enforcement agency, must disclose the address and phone number of the agency to the support creditor, must provide an explanation of the rights of the support creditor and must notify the support assistance agency in the state in which the holder resides of the name, address and telephone number of the holder of the claim.

11 U.S.C. § 1302(d)(1): A Chapter 13 trustee must make a disclosure to a child support creditor at the time of the discharge regarding the debtor's last known address, the address of the debtor's last employer, and the name of every creditor that holds a claim is not discharged under 11 U.S.C. § 523(a)(2) or (4) or that is reaffirmed.

11 U.S.C. § 1302(d)(1):

(1) In a case described in subsection (b)(6) to which subsection (b)(6) applies, the trustee shall—

(A)

(i) provide written notice to the holder of the claim described in subsection (b)(6) of such claim and of the right of such holder to use the services of the State child support enforcement agency established under sections 464 and 466 of the Social Security Act for the State in which such holder resides, for assistance in collecting child support during and after the case under this title; and

(ii) include in the notice provided under clause (i) the address and telephone number of such State child support enforcement agency;

(B)

(i) provide written notice to such State child support enforcement agency of such claim; and

(ii) include in the notice provided under clause (i) the name, address, and telephone number of such holder; and

(C) at such time as the debtor is granted a discharge under section 1328, provide written notice to such holder and to such State child support enforcement agency of—

(i) the granting of the discharge;

(ii) the last recent known address of the debtor;

(iii) the last recent known name and address of the debtor's employer; and

(iv) the name of each creditor that holds a claim that—

(I) is not discharged under paragraph (2) or (4) of section 523(a); or

(II) was reaffirmed by the debtor under section 524(c).

11 U.S.C. § 1306(a): Property of the estate includes, in addition to the property specified in section 541 of this title —

(1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first; and

(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first.

11 U.S.C. § 1307(c)(11): It is grounds to dismiss a Chapter 13 case if the debtor has failed to maintain post-petition payments on a domestic support obligation that first becomes payable after the filing of the petition. The failure to pay a post-petition support obligation permits a Court to dismiss the case; dismissal is not mandated.

11 U.S.C. § 1322(a)(4): A Chapter 13 plan need not pay in full the priority obligations of 11 U.S.C. § 507(a)(1)(B) [domestic support obligations assigned to a governmental entity] if the plan is a five (5) year plan in which the debtor is paying all disposable income.

11 U.S.C. § 1322(b)(10): A Chapter 13 plan may provide for the payment of interest accruing post-petition on any unsecured claim that is non-dischargeable but only if the debtor has proposed a plan that pays all allowed claims in full.

11 U.S.C. § 1325(a)(8): A Chapter 13 plan cannot be confirmed unless the debtor demonstrates that all post-petition support payments have been made. BAPCPA added a new confirmation standard in ***11 U.S.C. § 1325(a)(8)*** which states….

> (a) Except as
> provided in subsection (b), the court shall confirm
> a plan if –
> (8) the debtor has paid all amounts that are required
> to be paid under a domestic support obligation and
> that first become payable after the date of the filing
> of the petition if the debtor is required by a judicial
> or administrative order, or by statute, to pay such
> domestic support obligation;

11 U.S.C. § 1328(a): A Chapter 13 debtor may not receive a discharge unless the debtor certifies that all amounts due to a support obligation are fully paid. Specifically, section 1328(a) states….

> 11 U.S.C. § 1328 Discharge
>
> (a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt—

Straight & Narrow

By Hon. Cynthia A. Norton[1]

Ethical Implications of Valuing Assets in Bankruptcy

Hon. Cynthia A. Norton
U.S. Bankruptcy Court (W.D. Mo.) Kansas City

Chief Judge Cynthia Norton was appointed Feb. 1, 2013, to the U.S. Bankruptcy Court for the Western District of Missouri. Prior to her judicial appointment, she was a founding member of Grimes & Rebein, LC, where she practiced bankruptcy and commercial law.

"Value," observed Justice Louis Brandeis, "is a word of many meanings."[2] Yet how many lawyers think about what the term "value" means for purposes of the Bankruptcy Code? Do you thoughtfully counsel clients about how to value assets? Do you believe that a garage sale or pawn shop value is what the schedules require? This article discusses recent developments illustrating why bankruptcy lawyers should consider their clients' duty to value assets more carefully, and what ethical and malpractice considerations may be implicated if they fail to do so.

Valuation Basics

A debtor has a duty to file a schedule of assets and liabilities.[3] The schedule of assets must be filed on the appropriate Official Form.[4] "Asset" has not been defined in the Bankruptcy Code, but given the expansive nature of what constitutes "property of the estate,"[5] even assets with nominal or no value must nonetheless be scheduled.[6] Severe repercussions exist for debtors — and sometimes their lawyers — when assets are undervalued or omitted altogether. Undervalued assets have resulted in denial of exemptions,[7] denial of discharge,[8] bad-faith findings,[9] sanctions[10] and even criminal penalties.[11]

"Value" is a term used repeatedly in the Bankruptcy Code, but, with a few exceptions,[12] it is not defined. "Fair market value" (FMV), which denotes a relatively higher valuation, is universally defined as "the price that a seller is willing to accept and what a buyer is willing to pay on the open market and in an arm's-length transaction."[13] Terms denoting higher valuations include "retail," "going concern," "replacement cost" or "rehabilitation." On the other hand, "wholesale," "foreclosure," "liquidation," "garage sale," "pawn shop" or other quick-sale values generally denote a lower value.[14]

Another wrinkle is that value inherently incorporates a consideration of time or timing; what something is worth today may increase if more time exists to find that willing buyer.[15] With few exceptions,[16] the Code also does not specify on what date an asset should be valued. How, then, should debtors and their counsel determine what value methodology to use in valuing assets?

What Do the Schedules Say?

It may come as a surprise to learn that what the schedules require has changed. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Schedules A and B required "the current market value of debtor's interest in property."[17] Few cases delved into what "current market value" meant, but as one judge at the time observed, "While the case law is sparse on the subject, the majority, and better-reasoned, line of authority holds that personal property should be listed in the debtor's schedules at fair-market, rather than liquidation, or distressed-sale, value."[18]

Schedules A and B changed effective December 2007 to provide that a debtor's interest in assets must be scheduled based on the "current value."[19] The comments in the Rules Committee archives do not explain the basis for this modification, but given the other changes BAPCPA wrought in 2005, practitioners scarcely noticed this difference. With the wholescale changes in the forms effective Dec. 1, 2015, however, what methodology a debtor

1 The author thanks law clerks **Trevor Bond** and **Zachary Fairlie** for their editing assistance on this article.

2 *Missouri ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n of Missouri*, 262 U.S. 276, 310 (1923) (Brandeis, J., concurring).

3 Unless the court orders otherwise. 11 U.S.C. § 521(a)(1)(B)(i).

4 Fed. R. Bankr. P. 1007(b)(1)(A) (except for chapter 9 debtors).

5 *See* 11 U.S.C. § 541(a).

6 *In re Unruh*, 278 B.R. 796, 805 (Bankr. D. Minn. 2002) ("[T]he value of assets are not determinative of their materiality.") (citations omitted).

7 *In re Kelley*, 255 B.R. 783 (Bankr. N.D. Ala. 2000).

8 *See, e.g., In re Pynn*, 546 B.R. 425 (Bankr. C.D. Cal. 2016) (denying discharge for false oath under § 727(a)(4)(A) in undervaluing assets).

9 *See, e.g., In re Simpson*, 306 B.R. 793 (Bankr. D.S.C. 2003) (bar on refiling and sanctions imposed for, *inter alia*, significant undervaluation of assets).

10 *In re Engel*, 246 B.R. 784, 793-95 (Bankr. M.D. Pa. 2000) (imposing $2,500 sanction under court's inherent authority for counsel's casual approach to filing of bankruptcy schedules and dilatory response in amending known deficiencies).

11 *United States v. Walker*, 29 F.3d 908 (4th Cir. 1994) ($245,000 undervaluation of assets is considered a bankruptcy fraud under 18 U.S.C. § 152).

12 For purposes of exemptions, "value" is defined as FMV "as of the date of the filing of the petition." 11 U.S.C. § 522(a)(2). "New value" and "value" are also defined for purposes of preferential and fraudulent transfers, respectively. 11 U.S.C. §§ 547(a)(2) and 548(d)(2)(A). The other notable exception is the value of secured claims under § 506(a)(1)-(2). *See Assocs. Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (discussing differing standards for determining value of creditor's secured claim).

13 *In re Valentine*, No. 08-12074-JMD, 2009 WL 3336081, at *8 (Bankr. D.N.H. Oct. 14, 2009) (citing "fair market value," *Black's Law Dictionary* 1691 (9th ed. 2009)).

14 *See generally In re Johnson*, 145 B.R. 108, 115 n.10 (Bankr. S.D. Ga. 1992), *rev'd on other grounds*, 165 B.R. 524 (S.D. Ga. 1994).

15 "Logic and common sense inform us that the amount that can be realized from the sale of an asset varies as a function of the time period over which the asset must be sold." *In re Trans World Airlines Inc.*, 134 F.3d 188, 194 (3d Cir. 1998).

16 *See, e.g.*, 11 U.S.C. §§ 506(a)(2) and 522(a)(2) (date of filing); 1129(a)(7), 1225(a)(4) and 1325(a)(4) (value as of plan's effective date).

17 Official Form B6A (06/90).

18 *In re West*, 328 B.R. 736, 750 (Bankr. S.D. Ohio 2004).

19 B6A (Official Form 6A) (12/07). All official forms and instructions are *available at* uscourts.gov/services-forms/forms.

should use in valuing assets is now expressly established in the instructions as FMV:

> In this form, report the *current value* of the property that you own in each category. *Current value* is sometimes called *fair market value*, and, for this form, is the fair market value as of the date of the filing of the petition. *Current value* is how much the property is worth, which may be more or less than when you purchased the property.[20]

Likewise, Schedule C was amended at the same time to allow a debtor to exempt "100% of fair market value, up to any applicable statutory limit," by checking a box, implementing the U.S. Supreme Court's suggestion in *Schwab v. Reilly*[21] that to exempt an asset — as opposed to the value of the interest — debtors needed to use 100 percent FMV to give notice of that intent.[22]

The *Ayobami* Case

Only one case has discussed the changes to Schedules A/B and C. In *In re Ayobami*,[23] the chapter 13 debtor, utilizing federal exemptions, checked the box to exempt "100% of fair market value" of certain assets. Based on the debtor's values, the bulk of the exemptions were within the dollar limitations set forth in § 522(d). However, the chapter 13 trustee objected, arguing that it is facially objectionable for a debtor to check that box when claiming federal exemptions.[24] The chapter 13 trustee argued that the "100% of fair market value" language in the Schedule C serves only a notice function and does not result in removing the interest in the asset from property of the estate. The trustee expressed concern that the assets might have been undervalued or might appreciate, and that if the debtor later sold the property during the life of the chapter 13 plan, the debtor should still be limited to the dollar value of the exemption such that the estate — and not the debtor — would receive the benefit of any appreciation.[25]

The bankruptcy court disagreed with the trustee and reasoned that both § 522 and *Schwab* authorize a debtor to claim a "100% of fair market value" exemption, provided that the debtor assigns a dollar value to the exempted interest and that the value of the interest does not exceed the exemption's statutory cap.[26] The bankruptcy court stated that if an interested party objects, the court will then hold a valuation hearing; if the debtor succeeds, the interest ceases to be property of the estate,[27] and any later increases in value or appreciation will inure to the debtor's benefit. The court recognized the additional administrative

20 Instructions to Schedule A/B Property (Official Form 106 A/B) (12/15) (emphasis in original).
21 560 U.S. 770 (2010).
22 Schedule C (Official Form 106C) (04/16).
23 No. 15-35488, 2016 WL 828743 (Bankr. S.D. Tex. March 2, 2016), *supplemented*, 2016 WL 3854052 (June 9, 2016), *direct appeal recommended*, 2016 WL 3708761 (July 1, 2016) (appeal to Fifth Circuit pending).
24 *Ayobami*, 2016 WL 828743, at *1 (determining the gravamen of the trustee's objection was that it was not discernable what interests in the property were actually exempt).
25 *Id.* at *5.
26 *Id.* at *9 (supplemental opinion).
27 *Id.* The court pointed out that pursuant to *Schwab*, if the "100% of fair market value" exemption is successful, the estate will still retain the bare legal title to the asset.

continued on page 68

News at 11: Ensuring Enforcement of the Eleventh-Hour Mediation Deal

from page 67

documents evidencing and effectuating the deal will be drafted, the parties intend to immediately be bound by the eleventh-hour agreement and that the agreement is not contingent on or subject to the completion of the yet-to-be-drafted documents. That is, the contemplated formal documentation of the deal is not a condition precedent to formation of the contract. The provision should also note that the parties agree that the agreement is not subject to revocation.

Filing the Mediator's Report

In those jurisdictions that require the mediator to file a report with the court, the mediator should file a report as soon as possible noting that a settlement has been reached. Further, the report should specify that the settling parties have agreed that the settlement is immediately binding and enforceable, even though some non-material matters may have been left open for further negotiation.

Court-Approval Procedures

Last, but not least, to ensure enforcement, parties should be careful to follow local rules. For example, the U.S. Bankruptcy Court for the Eastern District of Michigan requires that a settlement agreement resulting from mediation be reduced to writing and a Rule 9019 motion seeking approval of the agreement be filed with the court no later than 14 days after full execution of the agreement.[41] abi

41 *See* Bankr. E.D. Mich. Local R. 7016-2(a)(5).

Straight & Narrow: Ethical Implications of Valuing Assets in Bankruptcy

from page 23

burden on trustees, but noted that Rule 4003(b)(2) extends the time for a party to object to exemptions for one year after the case has been closed if the exemption was fraudulently claimed.[28]

Ayobami is the first reported decision to highlight the change in Schedule A/B and the instruction to debtors that current value means FMV, not garage sale or pawn shop value. It also serves as a reminder that the "100% of fair market value" exemption should be considered carefully; if *Ayobami* is correct, the debtor may face a valuation hearing, costing time and money for which counsel might not have planned. If the Fifth Circuit overturns *Ayobami*, trustees in other circuits are then likely to challenge the "100% of fair market value" election. Even if not challenged, any debtor who sells property exempted with the "100% of fair market value" box also needs to know that the exemption might be overturned at a future date if the value or exemption of such property is later challenged as fraudulent.

Judicial Estoppel

Application of judicial estoppel has exploded since the Supreme Court recognized the doctrine in the seminal case of *New Hampshire v. Maine*.[29] As the doctrine has both exploded and expanded, so have the implications for valuing assets. Judicial estoppel prevents a party from taking a position in one case that is inconsistent with a position taken in another case, particularly where the party seeking to assert the inconsistent position would derive an unfair advantage.[30] The doctrine typically arises when a debtor fails to disclose a potential or pending cause of action,[31] but it would also arise in valuation contexts.[32]

28 *Id.* ("Of course, it is not fraudulent to hold an asset that increases in value. Conversely, it likely would be fraudulent to knowingly misrepresent the fair value of an asset in order to enable an interest in that asset to be claimed as exempt. The Rules adequately provide for the integrity of the bankruptcy exemption scheme.").
29 532 U.S. 742 (2001).
30 *Id.* at 751.
31 *See, e.g., Jones v. Bob Evans Farms Inc.*, 811 F.3d 1030 (8th Cir. 2016).
32 *In re Wertz*, 557 B.R. 695, 708-09 (Bankr. E.D. Ark. 2016).

In *Neidenbach v. Amica Mutual Insurance Co.*,[33] the chapter 13 debtors listed $7,000 of household goods and furnishings and a $300,000 home. Within a year after filing, a fire destroyed nearly everything. The debtors claimed a loss under their homeowner's policy of $262,500 for their personal property and $375,000 for the real estate, and sued the insurance company for reimbursement.[34]

> **A debtor's lawyer must also not only counsel the debtor about the duty to value assets accurately, but as a debt-relief agency, must advise of the risks of filing for bankruptcy....**

The district court granted summary judgment in favor of the insurance company, determining that the policy was void for material misrepresentation.[35] The court rejected the debtors' argument that the $7,000 value in the bankruptcy schedules was only a garage sale value, finding that the $255,000 difference between the value in the schedules and the value in the proof of loss could not be reconciled, even assuming that the forms called for different methods of calculation.[36] To make matters worse, the court in a subsequent opinion ordered that the debtors reimburse the insurance company the $58,709.85 it had been paid out under the policy for relocation and other expenses immediately after the fire.[37]

The *Neidenbach* court did not use the phrase "judicial estoppel," but the import is clear: Lowball values not only voided the debtors' homeowner's policy, they subjected the

33 96 F. Supp. 3d 925 (E.D. Mo. 2015).
34 *Id.* at 928.
35 *Id.* at 935.
36 *Id.* at 932.
37 *Neidenbach v. Amica Mut. Ins. Co.*, 161 F. Supp. 3d 731, 741 (E.D. Mo. 2016) (also denying insurer's request for indemnity of all losses, but noting split of authority).

debtors to a fraud-based debt owed to the insurer. In light of the explicit changes to Schedule A/B, it is not acceptable to advise a debtor to use a garage sale or pawn shop value for assets unless such value is truly an FMV. A debtor's lawyer must also not only counsel the debtor about the duty to value assets accurately, but as a debt-relief agency must also advise of the risks of filing for bankruptcy,[38] which may include a later voidance of a homeowner's policy if the bankruptcy asset values cannot be reconciled with a subsequent proof of loss.

Practice Tips

- *Explain:* Explain to your clients the duty to not only list all assets, but to value the assets at an FMV as of the date of filing, and the ramifications for failure to do so.[39]
- *Ask:* Ask your clients to provide a rational basis for the values they offer. Was the value based on purchase price? An appraisal? A listing price or offer to purchase?[40] Ask for proof.
- *Verify:* Cross-check pertinent documents such as financial statements, divorce decrees and insurance policies for values, and consult accepted valuation guides.
- *Disclose:* Disclose the basis and methodology of the valuation when you list an asset in the schedules.
- *Beware of red flags:* Unknown or $0 values may raise a red flag, as does a list of assets with differing valuation methodologies.[41] Likewise, be wary of a client who is a collector or who appears to have some knowledge of values, particularly if the client insists on a lowball value.[42]
- *Difficult-to-value assets:* Courts recognize that some assets might be difficult to value. Nonetheless, debtors must have a good-faith basis for the value.[43]
- *Duty to amend:* Once you learn that an asset has been undervalued, you must counsel your clients on the duty to promptly amend. Failure to amend is often considered evidence of recklessness or fraudulent intent sufficient to support denial of discharge.[44]

Conclusion

Failing to advise clients about how to properly value assets invokes Model Rules of Professional Conduct 1.4(b) (communication), 2.1 (duty to advise) and 3.3 (candor to the tribunal).[45] It might subject lawyers to Rule 11 or other sanctions. More importantly, debtors whose homeowner's policies are voided or whose discharges are denied for undervaluing assets may blame their lawyers for the bad result. Be aware of bankruptcy valuation standards and advise your clients accordingly.

38 11 U.S.C. § 526(a)(3)(B).
39 *See Engel*, 246 B.R. 784.
40 *See Kelley*, 255 B.R. 783.
41 *In re Zimmerman*, 320 B.R. 800 (Bankr. M.D. Pa. 2005).
42 *In re Pynn*, 546 B.R. 425 (Bankr. C.D. Cal. 2016).
43 *In re Spitko*, 357 B.R. 272, 315 (Bankr. E.D. Pa. 2006).
44 *Engel*, 246 B.R. at 790.
45 *Id.* at 791-93.

The International Scene: COMI of Offshore Funds, Revisited

from page 31

COMI was not the Cayman Islands because there were no employees there, the investment manager and administrator were located in the U.S., the funds' assets were in the U.S., the funds' investor registries were located in Ireland, and accounts receivables and repo/swap counterparties were all outside the Cayman Islands. In addition, Judge Lifland further found that the funds lacked an establishment since they were "exempted companies" under Cayman law and unable to conduct business there.[25] The district court affirmed, giving little weight to the fact that the foreign representatives had moved the funds' liquid assets to Cayman bank accounts post-petition, and pointed out that those assets were with U.S. brokerage accounts prior to the chapter 15 filing.[26]

Alpha

Similarly, *Alpha* involved yet another Cayman Islands investment fund that folded under the weight of rising subprime lending defaults. The foreign representatives moved for summary judgment on recognition, relying heavily on the absence of objections and the statutory presumption.[27] Citing directly to the statute that the COMI is presumed to be the location of the fund's registered office "[i]n the absence of evidence to the contrary," the foreign representatives argued that they need not otherwise make an affirmative showing. Hon. **Robert E. Gerber** (ret.) disagreed, stating that the foreign representatives' silence on the traditional COMI factors was "deafening." Furthermore, the bankruptcy court also found "[a]mong the few facts ... put forward" that the Alpha fund was a Cayman Island "exempted company," serving as "evidence to the contrary" to rebut the statutory presumption.[28]

Fairfield Sentry

Fairfield Sentry was incorporated in the British Virgin Islands (BVI) in 1990 and operated as a feeder fund for Bernard L. Madoff Investment Securities LLC. Several months after Madoff's arrest, Fairfield Sentry was put into a BVI liquidation proceeding by 10 of its shareholders, and liquidators were appointed in July 2009.[29] About a year later, the liquidators (as foreign representatives) filed a chapter 15 petition for recognition of the BVI primary liquidation. Certain Fairfield Sentry shareholders, who had filed a derivative suit against Fairfield Sentry management and others in New York state court, objected to recognition. The bankruptcy court recognized the primary liquidation as a foreign main proceeding over the shareholders' objection, and the district court affirmed.

Two related issues were examined by the Second Circuit on appeal: (1) whether a COMI is measured as of the filing of the primary liquidation or the later filing of a chapter 15 peti-

25 *Id.* at 131.
26 *Bear Stearns II*, 389 B.R. at 338.
27 *Alpha*, 381 B.R. at 43.
28 *Id.* at 48-49.
29 *Fairfield Sentry*, 714 F.3d at 130-31.

continued on page 70

37th Annual Midwestern Bankruptcy Institute
Kansas City Marriott Downtown
200 W. 12th St.
Kansas City, Missouri

October 26-27, 2017

The Section 1111(b)(2) Election

Judge Robert E. Nugent III
U.S. Bankruptcy Court, District of Kansas

The Problem

Metcalf Hotel, L.L.C. owns the Mar-a-Pondo Hotel which overlooks a small body of water in Overland Park. Metcalf files a chapter 11 reorganization case. Metcalf's principal secured creditor, Lodgebank, holds a $10.0 million non-recourse note that is secured by a first mortgage on the hotel, a security interest in its equipment, and an assignment of rents and accounts receivable. Post-petition, Lodgebank assigns its claim to HedgeLender Fund for $5.0 million. Metcalf files a plan stating the value of Hedge's collateral (the hotel and other assets) is $4.0 million and proposing to cram Hedge down under § 1129(b)(2) by bifurcating its secured claim, treating the balance of the claim as unsecured. Obviously, there is little hope of a dividend for the unsecured creditors. Hedge thinks its collateral is worth *much* more and files a motion under § 506 and Rule 3012 seeking an order that the hotel's value is $11.0 million. Hedge also asks for more time to make an § 1111(b) election, at least until the valuation hearing is completed.

After hearing from two appraisers, the court values the Mar-a-Pondo at $6.0 million for purposes of plan confirmation and allows Hedge's secured claim in that amount. Hedge files its § 1111(b) election and Metcalf amends the plan to incorporate the court's valuation and propose fully-secured treatment. But, shortly before the confirmation hearing on Metcalf's plan, Hedge files a competing plan of reorganization in which it proposes to bifurcate its claim into a secured portion (based upon the court's valuation) and a general unsecured claim (for the deficiency).

Questions for Discussion

1. What are some situations in which a creditor should consider exercising the election?
    a. Difficult-to-value collateral or down market.
    b. Rising market.
    c. Debtor cannot pay in full, forcing forfeiture or foreclosure.
2. When might it be better to preserve your §1111(b)(1)(A) recourse status?
    a. Sale in prospect; you can still credit bid, §363(k) up to the amount of your "allowed claim," i.e. all of it.
3. Downsides to election?
    a. If you were a non-recourse creditor before, the loss of recourse unsecured deficiency claim—no dividend and no ability to block voting in the unsecured class.
    b. Lower interest rates may allow debtor to string out secured claim payout.
4. Debtor responses to election?
    a. Interest in collateral is inconsequential?
    b. Propose lengthy payout at lower interest rates?
5. Can you un-elect?
    a. If you're non-recourse, the nature of your claim has changed.
    b. Surest way out of the election is the failure of the plan to be confirmed. "Only if the plan is not confirmed may the class of secured creditors thereafter change its prior election." Adv. Comm. Notes, Fed. R. Bank. P. 3014 (1983).
    c. What about filing your own plan?
6. How do we treat the elected claim in the plan?

Analysis

I. What is the "1111(b)(2) election?"

A. Section 1111(b)(2) is better understood in context with subsection (b)(1). Section 1111(b)(1)(A)(i) converts prepetition nonrecourse claims into recourse claims. It provides that secured claims will be allowed or disallowed under § 502 as a claim with recourse against the debtor, whether or not recourse exists outside of bankruptcy law, unless the creditor class "elects" subparagraph (b)(2) treatment [a nonrecourse claim]:

> A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless – (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection;[1]

See also In re 680 Fifth Ave. Associates, 29 F.3d 95, 97 (2nd Cir. 1994):

> As stated by the bankruptcy court, '[i]n Chapter 11, § 1111(b) determines the treatment of undersecured claims secured by liens on property of the estate.' . . . Section 1111(b) allows an undersecured creditor either to elect to have its entire claim treated as secured, or to have the claim bifurcated into secured and unsecured portions, notwithstanding the fact that under 11 U.S.C. § 502(b)(1), the nonrecourse nature of the loan would otherwise bar a deficiency claim for the unsecured portion of the loan.

[1] 11 U.S.C. § 1111(b)(1)(A)(i).

Note that, in most cases, each secured creditor is classified into a single class of its own.

B. By making the "election" under § 1111 (b)(1)(A)(i) a secured creditor elects to decline recourse treatment of its claim, rendering it fully secured to the extent it is allowed per §1111(b)(2). *See In re 680 Fifth Ave. Associates*, 29 F.3d 95, 97 (2nd Cir. 1994) (impetus behind enactment of § 1111(b) was to protect the rights of nonrecourse lienholders in chapter 11 reorganizations by providing that a claim secured by a lien on property of the estate is treated as giving the lienholder recourse against the debtor, whether or not recourse exists under non-bankruptcy law or the creditor's loan documents.).

C. There are two circumstances in which a secured creditor may not elect: when its security has little or no value or when its security is to be sold under §363 or under the plan. Subsection (b)(1)(B) describes these circumstances:

> (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
> (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title, or is to be sold under the plan.[2]

1. The inconsequential value limitation arises in cases where senior secured creditors are undersecured and there is no collateral value to support a junior lienholder's claim. *See In re 500 Fifth Ave. Assocs.*, 148 B.R. 1010 (Bankr. S.D. N.Y. 1993) (creditor whose subordinate lien was

[2] 11 U.S.C. § 1111(b)(1)(B).

completely unsecured could not elect to have its claim treated as wholly secured under § 1111(b)), *aff'd* 1993 WL 316183 (S.D.N.Y. May 21, 1993). *See also In re Tuma*, 916 F.2d 488 (9th Cir. 1990) (issue of whether controlling stock in newly reorganized corporation pledged to undersecured creditor was of "inconsequential value" and precluded creditor's § 1111(b) election).

2. The "sale" limitation on a recourse creditor's electing under § 1111(b) exists because the secured creditor may already protect its interest by credit bidding its debt at the sale and recovering the collateral, thus receiving the benefit of its bargain without the special treatment of § 1111(b). Note that this exception specifically applies only to recourse creditors. In a case where the undersecured creditor did not have a lien on all of debtor's assets but the § 363 sale was of debtor's assets in bulk, implications for credit bidding were discussed. *See In re R.L. Adkins Corp.*, 784 F.3d 978 (5th Cir. 2015) (undersecured mechanic's lien claimant against debtor's mineral interests was not entitled to § 1111(b)(2) election where plan proponent recognized mechanic's lien and proposed a § 363 sale of debtor's mineral interests in its plan with creditor's right to credit bid at the sale; concurring opinion held that mechanic's lien claimant waived its § 1111(b) election by failing to pursue it at the confirmation hearing, and noting court

should settle objections to creditor's § 1111(b) election prior to the confirmation hearing.).

II. What is the effect of making the § 1111(b)(2) election?

A. When a creditor makes a § 1111(b) election, it opts to have its allowed claim treated as a fully secured and waives its unsecured claim for any deficiency, notwithstanding § 506(a)'s bifurcation of its claim into secured and unsecured portions, changing how the debtor must treat the fully secured claim. *See* §§ 1111(b)(2) and 1129(b)(2); *see also* paragraph II.C below. Note that any secured creditor may elect whether it was recourse or nonrecourse prepetition, subject to the limitations of § 1111(b)(1)(B). By electing, the secured creditor waives its recourse status and its collateral is deemed to have the same value as the claim.

1. In our fact pattern, Hedge's fully secured claim would be allowed at $10.0 million. If Hedge hadn't made the § 1111(b)(2) election, its allowed secured claim would be $6.0 million and its general unsecured claim would be $4.0 million.

B. The election is binding with respect to the plan. Fed. R. Bankr. P. 3014. Only if confirmation of that particular plan is denied or if the plan is materially modified after the election is the election no longer binding. *See* Advisory Committee Notes to Rule 3014; 9 COLLIER ON BANKRUPTCY ¶ 3014.01[4] (16th ed.).

1. In our pattern, Metcalf's amendment of its plan Hedge elected wasn't a material modification; the modification was required to reflect the court's determination of the value of the collateral and the election was based upon the court-determined valuation on Hedge's § 506 motion.

C. Section 1129(b)(2) – Comparative treatment of a bifurcated claim with an elected-to claim in a plan.

1. Suppose Hedge had stood pat on the claim it acquired. Its $10.0 million claim, secured by $6.0 million of collateral, would be treated as two claims, a $6.0 million secured claim and a $4.0 million unsecured claim. The secured portion would be entitled to treatment that allowed Hedge to retain its lien and to receive "deferred cash payments" totaling the allowed amount of the [fully-secured] claim and having "a value, as of the effective date" of the value of the collateral.[3] Thus, Hedge would receive the equivalent of a note for $6,000,000 at a market rate of interest that is secured by the hotel assets and whatever pro rata dividend the debtor can pay in connection with Hedge's $4,000,000 unsecured claim.

2. But Hedge elected up. That means it is entitled to retain its lien and to receive "deferred cash payments" totaling the allowed amount of the [fully-secured] claim and that have "a value, as of the effective date" of the value of the collateral. Because Hedge is now fully secured, its stream of

[3] 11 U.S.C. § 1129(b)(2)(A)(i). Or the debtor could propose to sell the Mar-a-Pondo and pay Hedge the proceeds or surrender the hotel, § 1129(b)(2)(A)(ii), or otherwise provide Hedge with the indubitable equivalent of its claim, §1129(b)(2)(B)(iii).

payments must total $10,000,000 while having a present value of $6,000,000. *See First Fed. Bank of Cal. v. Weinstein (In re Weinstein),* 227 B.R. 284, 294 (9th Cir. BAP 1998). Another way to look at this is that the creditor will receive a note for $10,000,000 note at confirmation that is only worth $6,000,000 because of a below-market interest rate (or maybe even no interest) depending on the duration of the payment schedule.

a) The shorter the term, the higher the effective interest rate. A note could also provide for a prepayment or cash-out that includes an amount sufficient to pay the total amount of the allowed claim—the §1111(b) "premium." This must be so; if the creditor received a $6.0 million note with payments totaling $10.0 million, without the "premium" provision, the debtor could cash out for $6.0 million the day after confirmation and leave the creditor shy $4.0 million, but without an unsecured claim for its deficiency. *See In re Brice Road Developments, L.L.P.*, 392 B.R. 274, 284-287 (6th Cir. B.A.P. 2008); *In re Weinstein*, 227 B.R. 284, 294 (9th Cir. B.A.P. 1998).

3. The interest portion of the payments apply to reduce the allowed secured claim. *See* James A. Pusateri, et al., Section 1111(b) of the Bankruptcy Code: How Much Does the Debtor Have to Pay and When Should the Creditor Elect? 58 Am. Bankr. L.J. 129, 136–41 (1984).

4. Payment by partial surrender is not available. *See In re Griffiths,* 27 B.R. 873, 876 (Bankr. D. Kan. 1983) (Partial surrender of collateral plus

payment of remaining collateral's value not the indubitable equivalent of lender's §1111(b)(2) claim, rather payment of the balance of the claim itself is).

III. Procedures for the § 1111(b)(2) election.

A. Timing: Rule 3014 provides that a secured creditor may make an election at any time before the conclusion of the hearing on the disclosure statement. Fed. R. Bankr. P. 3014. In a small business case, if the disclosure statement is conditionally approved, a § 1111(b) election must be made no later than the deadline for objecting to the disclosure statement or such other date the court may fix. *See* Rule 3014.

1. The court may extend the time to make a § 1111(b) election for cause -- to prevent the secured creditor from having to make an election prior to the court's valuation of its secured claim under § 506(a) and Rule 3012. *See* Fed. R. Bankr. P. 9006(b) (but court cannot reduce the time for an election, Rule 9006(c)(2)); Alan N. Resnick & Henry J. Sommers, eds., 7 COLLIER ON BANKRUPTCY ¶ 1111.03[4] and 9 COLLIER ON BANKRUPTCY ¶ 3014.01[3], n. 14 (16th ed.). In the above scenario, Hedge filed its motion to extend the time to elect until after the court's ruling on its § 506 motion. Thus, there was cause for the extension.

B. Writing: Unless the creditor elects at the disclosure statement hearing, the election must be in writing and signed by the creditor or creditor's counsel. *See* Fed. R. Bankr. P. 3014.

C. CM/ECF does not have a dedicated docket event for § 1111(b) elections, so the creditor should file the election as a "Notice." But the writing should itself be designated as an election under § 1111(b) in the title. *See* Fed. R. Bankr. P. 9004(b). The election should indicate the name of the creditor, the amount of the claim, the collateral, and identify the plan.

IV. Can a secured creditor "un-elect" or withdraw its election?

A. As noted above, absent denial of confirmation or a material modification of the plan to which the secured creditor elected, the election cannot be undone. *See In re Bloomingdale Partners*, 155 B.R. 961 (Bankr. N.D. Ill. 1993) (undersecured mortgage holder could not withdraw its election); Adv. Comm. Notes, Fed. R. Bankr. P. 3014 (1983), stating "Only if the plan is not confirmed may the class of secured creditors thereafter change its prior election." *See also, In re Keller*, 47 B.R. 725 (Bankr. N.D. Iowa 1985) (secured creditor cannot withdraw its election unless debtor materially modifies its plan ["tantamount to filing a different plan"] after the § 1111(b) election is made); *In re Century Glove, Inc.,* 74 B.R. 958, 961 (Bankr. D. Del. 1987) (upon debtors' modification or alteration of the plans, secured creditor must be given an opportunity to change its prior election; electing creditor must know the proposed treatment under the plan before it can intelligently determine its rights); *Matter of IPC Atlanta Ltd. Partnership*, 142 B.R. 547 (Bankr. N.D. Ga. 1992) (modifying a plan to clarify second lienholder's treatment and to clarify allocation of postpetition payments paid to electing creditor under prior order did not

amount to material modifications that would permit electing creditor to withdraw its election; in any event, electing creditor's notice of withdrawal of its election was untimely where it was filed several weeks after the plan modifications and after conclusion of confirmation hearing). *But see In re Scarsdale Realty Partners, L.P.,* 232 B.R. 300 (Bankr. S.D.N.Y. 1999) (Creditor's motion to withdraw election was granted where debtor's initial disclosure statement failed to disclose information material to creditor's election – that creditor's deficiency claim may enable it to dominate the unsecured class because one of the creditors in the unsecured class was an affiliate of the debtor and its right to vote on the plan could be challenged). It should be noted that in *Scarsdale Realty Partners,* the electing creditor's motion to withdraw its election was filed prior to conclusion of the hearing on the adequacy of the disclosure statement. Other cases also allow withdrawal of the election on the basis of material misstatements in the disclosure statement that prejudice the electing creditor. *See In re Stanley*, 185 B.R. 417 (Bankr. D. Conn. 1995).

B. Conditional elections. Two courts have addressed a creditor's attempted conditional election; neither creditor was successful. In *In re Western Real Estate Fund, Inc.*, 83 B.R. 52, 55 (Bankr. W.D. Okla. 1988), the electing creditor "declined to have its claim treated as fully secured in the event the court determined that the debtor could not eliminate the unsecured portion of its claim through a proposed future sale." That court denied confirmation of

debtor's plan containing the electing creditor's condition, directing debtor to modify plan providing creditors treatment if there were no election. It stated that the creditor's "purported" election "became an election not to be granted [§ 1111(b)(2)] treatment" when the court denied confirmation and directed debtor to modify it. *See also In re Paradise Springs Assocs.,* 165 B.R. 913 (Bankr. D. Ariz. 1993) (conditional or "under protest" elections are clearly not contemplated by Rule 3014; creditor sought its § 1111(b) election to be effective only in the event that the bankruptcy court determined debtor's plan that separately classified creditor's unsecured deficiency claim was confirmable).

C. Multiple Plans. Treatise authority suggests that a secured creditor may make different elections where there are multiple proposed plans. *See* Hon. Susan V. Kelley, GINSBERG & MARTIN ON BANKRUPTCY, § 13.14 (5th ed. Supp. 2016) (noting that the § 1111(b) election is made with respect to a specific plan and is binding only as to that plan); Alan N. Resnick & Henry J. Sommer eds., 9 COLLIER ON BANKRUPTCY ¶ 3014.01[5] n. 24 (16th ed.) (secured creditor may wish to make an election for fewer than all plans). Section 1129(c) provides that a court may confirm only one plan. In the above case scenario, Hedge's competing plan treats its claim as a recourse claim under § 1111(b)(1)(A)(i), after having elected a non-recourse claim to debtor's plan. Query whether this should be permitted?

V. Some §1111(b)(2) Election Strategic Considerations

A. When is the election a better deal?

1. Consider how far undersecured your creditor is. Remember that the unsecured claim, even in a low-dividend case, has tactical value in the confirmation process.

2. Does it matter that Hedge succeeded to the claim? *In re 680 Fifth Ave. Associates,* 29 F.3d 95, 98 (2nd Cir. 1994) holds that a creditor not in contractual privity with the debtor is entitled to elect; § 1111(b) applies to all lien claims against property of the estate. Hedge could elect under § 1111(b) even though it lacked contractual privity with the debtor.

3. Deciding to elect involves a good understanding of the markets. For instance, during recessionary times, lodging expenditures may suffer and hotels may lose value. But if the claim-holder suspects that the market value will recover, electing to preserve upside may be in order. Likewise, in a rising collateral market, creditors will want to guarantee their receiving cash in the future rather than allowing the debtor to cash out at a reduced value and reap the benefits of appreciation. This may be so when the secured creditor believes the § 506(a) judicial valuation undervalues the collateral.

4. Can the debtor afford to pay the now increased secured claim? If it can't pay the claim in full over time, that may force forfeiture or foreclosure. Does your client necessarily want the collateral back?

B. When might the creditor be better off to preserve its § 1111(b) recourse status and not elect?

1. Is a sale in prospect? Creditor can still credit bid at sale, § 363(k) up to the amount of creditor's "allowed claim," *i.e.* all of it.

2. If you were a non-recourse creditor before bankruptcy, § 1111(b)(1)(A)(i) automatically converts claim to recourse; if creditor elects nonrecourse it loses: (a) an unsecured deficiency claim and potential dividend; and (b) the ability to block voting in the unsecured class. There is some split in authority whether an undersecured creditor's deficiency claims may be classified with other general unsecured claims. *See Matter of Greystone III Joint Venture,* 995 F.2d 1274 (5th Cir. 1991) (separate classification unwarranted; proper classification ensures creditors with claims of similar priority are treated similarly); *In re Barakat*, 99 F.3d 1520 (9th Cir. 1996). *But see Matter of Woodbrook Associates*, 19 F. 3d 312 (7th Cir. 1994) (discussing limits on debtor's discretion to classify claims that are necessary to prevent gerrymandering and ensuring affirmative vote of at least one impaired class; undersecured creditor's unsecured deficiency claim must be separately classified from other general unsecured claims).

3. Risk of a lengthy payout – particularly if interest rates are low, debtor may be able to string out payment of secured creditor's claim.

4. Unencumbered assets for unsecured creditors – the plan may provide a substantial distribution to the general unsecured creditor class (*i.e.* deficiency claims of undersecured creditors). This is admittedly the exceptional case.

VI. Conclusion

The § 1111(b) election is a powerful weapon in reorganizations, but like all potent weapons, must be used with care for the consequences, both beneficial and adverse, to your client. Both debtors and creditors need to be wary of the potential pitfalls (and benefits) of the election, while keeping in mind its usefulness as negotiating template.

CHAPTER 9 QUICK REFERENCE

I. Judgments Against a Municipal Entity.

In Nebraska, "[a]s a general rule in the absence of a statute expressly granting such right, the land and property of the state or its agencies or political subdivisions is not subject to seizure under general execution." *Madison Cty. v. Sch. Dist. No. 2 of Madison Cty.*, 27 N.W.2d 172, 177 (Neb. 1947).

> Each county established under Nebraska law is a body politic and corporate that may sue and be sued in any court having jurisdiction over the subject matter. Neb. Rev. Stat. § 23-101. Whenever a money judgment is entered against a Nebraska county, the county board must "make provision for the prompt payment of the same." Neb. Rev. Stat. § 77-1619. If the amount of revenue derived from taxes levied and collected by the county for ordinary purposes is insufficient to pay a judgment entered against the county, the county must "at once proceed and levy and collect a sufficient amount of money to pay off and discharge such judgments." Neb. Rev. Stat. § 77-1620. If the county authorities responsible for levying and collecting the tax necessary to pay off any judgment "fail, refuse, or neglect to make provision for the immediate payment of such judgments, . . . such officers shall become personally liable to pay such judgments. . . ." Neb. Rev. Stat. § 77-1623.

Williams v. Cty. of Scotts Bluff, No. 7:05CV5018, 2005 WL 3159661, at *3 (D. Neb. Nov. 28, 2005).

The state is not responsible for payment of judgments against a county. *Id.*

However, the provisions of the Bankruptcy Code give the municipalities some leeway in dealing with their debts. Clearly in some cases raising taxes "at once . . . to collect a sufficient amount . . . to pay off [a] judgment" isn't a viable option, which is why municipalities have to resort to Chapter 9. The counties also have to abide by the state constitutional limit on their taxing powers (Art. VIII, § 5).

II. Requirements of a Chapter 9 Debtor.

Under § 109(c) ("who may be a debtor"), the debtor must

1. be a municipality
2. be authorized by state law to file bankruptcy
3. be insolvent (analyzed as of petition date), either
   a. not paying debts as they become due or
   b. unable to pay debts as they become due (requires a prospective analysis and a showing of a future inability to pay)

The nonpayment of undisputed amounts that a municipality can pay, the nonpayment of debts that are not due, or the nonpayment in bad faith are not insolvency.

4. desire to effect a plan to adjust debts (courts apply a subjective test and have generally considered direct, circumstantial, or other evidence indicative of the municipality's intent), and
5. before the petition is filed, have either
   a. reached an agreement with creditors, or
   b. negotiated in good faith with its creditors, or
   c. is unable to negotiate because negotiations would be impracticable, or
   d. reasonably believes a creditor may attempt to obtain a preference.

Under subsection (b), Chapter 9 debtors do not have to show that they have fully levied taxes to the maximum allowed by law. *In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 78 (Bankr. D.N.H. 1994). However, bankruptcy courts have found that municipal debtors have not acted in good faith where the debtors never exercised their assessment powers prior to initiating proceedings in bankruptcy court. *Id.* The New Hampshire court identified the imposition of higher taxes as a "bright-line rule" for Chapter 9 eligibility:

> Municipalities that wish to come into bankruptcy under Chapter 9 in my judgment must, at a minimum, demonstrate that before filing they either used their assessment or taxing powers to a reasonable extent, or in their pre-petition negotiations have committed to the use of those powers as part of a comprehensive and appropriate work out of their financial problems. If they have undertaken that endeavor in good faith, and nevertheless have failed to reach an accommodation with their creditors, they then may be entitled to Chapter 9 relief if they are otherwise qualified.

Id. at 83, *see also In re Ravenna Metro. Dist.*, 522 B.R. 656, 682 (Bankr. D. Colo. 2014).

III. Confirmation Standards.

A. Pursuant to § 943(b), the court shall confirm the plan if:
   1. the plan complies with the provisions of title 11 made applicable by sections 103(e) and 901;
   2. the plan complies with the provisions of Chapter 9;
   3. all amounts to be paid by the debtor or by person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
   4. the debtor is not prohibited by law from taking any action necessary to carry out the plan;
   5. except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507(a)(2) will receive on account of such claim cash equal to the allowed amount of such claim;

6. any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and
7. the plan is in the best interests of the creditors and is feasible.

B. "Best interests of creditors" is not defined in the Code. Some courts have refused to apply the Chapter 11 definition of "best interests of creditors" because liquidation is not an option under Chapter 9. A similar test is that a Chapter 9 debtor's plan must pay creditors more than they would receive if the case were dismissed, which essentially would force creditors to resort to mandamus actions to attempt to compel municipal officials to pay their claims out of tax collections or to raise sufficient taxes to pay their judgments.

C. The plan need not provide that all of the debtor's assets be used to satisfy its obligations (because the debtor has to continue operating), but the plan must be a reasonable effort to repay creditors over a reasonable period of time.

D. Feasibility considerations include whether the debtor will be able to service its debt going forward and whether it will be able to continue to provide public services at a level consistent with its function.

E. § 943(b)(4) prohibits confirmation of a plan that requires a municipality to take actions that are prohibited by state or local law. However, the court must consider that the reason the debtor is in Chapter 9 is because of its need for debt adjustment; § 943(b)(4) is intended to prevent the court from disregarding state laws *without allowing those state laws to undermine the core purpose of Chapter 9*. For instance, *see In re Sanitary & Improvement Dist.. No. 7*, 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (stating that "[t]o create a federal statute passed upon the theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debt is not . . . a logical or necessary result."). Collier's explains that courts have interpreted the confirmation requirements to mean that a Chapter 9 debtor can ignore many aspects of state law in the process of adjusting its debts, but must abide by state law after the plan is confirmed:

> [T]he debtor may take action or enter into transactions under the plan itself as necessary to adjust its debts without regard to state law, except for any required regulatory or electoral approval, but once the plan is confirmed and put in place, the debtor may not do things that are prohibited by state law. In other words, the confirmation of a chapter 9 plan does not exempt a municipality from future compliance with state law.
>
> 6 Collier on Bankruptcy P 943.03.

F. If the plan proposes actions such as tax increases or the issuance of bonds, then it cannot be confirmed unless the debtor explains how it will obtain the necessary voter approval and/or regulatory approval.

G. A plan can be approved that doesn't call for a tax increase if the court is convinced that raising taxes is not a realistic option.

H. Cramdown is permissible, if the plan doesn't discriminate unfairly and if the plan is fair and equitable with regard to each class of impaired claims that has not accepted the plan.

I. A successful plan of adjustment will do the following:
   1. Provide for adequate rainy day reserves;
   2. Leave the municipality with flexibility to adjust costs and service levels to account for future unforeseen downturns;
   3. Limit exposure to undue risks in the debt markets (by for example, relying on too much variable rate debt without appropriate hedges or cushions against rising rates);
   4. Avoid reliance on uncertain future revenue streams, particularly if they require voter approval or are otherwise outside the control of the municipality;
   5. Be supported by a consensus of at least a majority of the affected stakeholders, and backed by a meaningful commitment to implement the plan.

John Knox & Marc Levinson, *Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress*, at 34, The Orrick Public Finance Green Book Series (Mar. 26, 2009).

IV. Effect of Confirmation.

A. Pursuant to § 944(b), a debtor is discharged from all debts as of the time when
   1. the plan is confirmed;
   2. the debtor deposits any consideration to be distributed under the plan with a disbursing agent appointed by the court; and
   3. the court has determined that
      a. any security so deposited will constitute, after distribution, a valid legal obligation of the debtor; and
      b. any provision made to pay or secure payment of such obligation is valid.

B. Discharge may or may not be limited to pre-petition debt (§ 1141(d)(1)(A), which discharges a Chapter 11 debtor from pre-confirmation debts, is not applicable in Chapter 9), so the plan terms should carefully set out the scope of the discharge.

C. § 524(e) is inapplicable in Chapter 9, so third-party releases may be an option.

D. The court retains jurisdiction for as long as necessary for the successful implementation of the plan.

E. The court shall close the case when administration has been completed.

Third Party (Non-Debtor) Releases and Bar Orders in Chapter 11

Judge Barry S. Schermer
United States Bankruptcy Court for the Eastern District of Missouri

> [D]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.
>
> 11 U.S.C. § 524(e)

Courts are split concerning whether non-consensual, third-party releases are valid and enforceable in Chapter 11.

The majority view is that these third-party releases are valid and enforceable in limited and extraordinary circumstances. These courts rely on Bankruptcy Code §105(a) and the lack of any express restriction on such releases in § 524(e). Of the courts allowing the releases in the first instance, there is no consensus regarding what test to apply for approval, but some tests, each requiring a fact-intensive analysis, have evolved and are set forth in the case summaries below. Other courts have not ruled directly on the issue but have indicated a willingness to follow the majority view. Pending in a Delaware bankruptcy court on remand is the question of whether the bankruptcy court had the constitutional authority to approve a non-consensual third-party release in a Chapter 11 plan. *See Opt-Out Lenders v. Millenium Lab Holdings II, LLC (In re Millenium Lab Holdings, II, LLC)*, Bankr. Case No. 15–12284–LSS, Civ. No. 16–110–LPS, 2017 WL 1032992 (D. Del. March 20, 2017).

Minority courts interpret § 524(e) to strictly prohibit non-consensual third-party releases, except where provided under §524(g).

Case Law Examples - majority view, courts not directly ruling on issue, and constitutional authority issue

Monarch Life Ins. Corp. v. Ropes & Gray, 65 F.3d 973, 979-80 (1st Cir. 1995). The court did not rule on the issue of whether third-party releases in chapter 11 plans are valid, but it indicted a willingness to allow third-party releases when certain circumstances exist. In this case, a party was collaterally estopped from challenging the bankruptcy court's authority to approve a Chapter 11 plan provision which permanently enjoined lawsuits "arising from" or "related to" claims against the debtor, even if such lawsuits were against non-debtor third-parties such as debtor's attorneys for malpractice.

In re Grove Instruments, Inc., No-15-40733-CJP, 2017 WL 3025933 (D. Mass. July 14, 2017). The Chapter 7 trustee filed a complaint against former directors and officers of the debtor. The trustee and some of the defendants reached a settlement whereby a significant monetary payment would be made on behalf of the settling defendants from coverage under directors' and officers' insurance policies. The settlement was conditioned

upon the approval of a bar order prohibiting all persons (including certain objecting parties) from asserting any claim against the settling defendants "arising from actions . . . within the scope of their duties as officers and/or directors of [the Debtor] and is not intended to bar third party claims against the Settling [Parties] arising out of matters completely unrelated to such claims." The court pointed out that even in circuits permitting third-party releases, circumstances of some cases have led courts to decide that they did not have subject matter jurisdiction or adjudicatory authority to enter the injunction. Since the proposed settlement did not meet the standard the court would apply in considering a non-consensual third-party release in a Chapter 11 plan, it did not address the subject matter jurisdiction and adjudicatory issues. The court stated that when deciding that it should not exercise its discretion to approve the bar order, it reviewed all relevant factors "the relative benefits and burdens of the requested bar order, the relatedness of the claims sought to be enjoined, the fact that no party that would have an independent, third-party claim that would be barred by the requested order supports its entry, and whether the requested order would be fair and equitable to the [o]bjecting [p]arties."

In re Metromedia Fiber Network, Inc., 416 F.3d 136 (2d Cir. 2005). The court held that the bankruptcy court's findings were not sufficient to support the validity of the Chapter 11 plan's non-consensual third-party releases, but the court dismissed the appeal of the releases as equitably moot. A trust established by insiders of a debtor offered a contribution. In return, the trust and certain non-debtor insiders would receive stock in the reorganized debtors and a broad release from "any holder of a claim of any nature . . . any and all claims, obligations, rights, causes of action and liabilities arising out of or in connection with any matter related to [the debtors] . . . based in whole or in part upon any act or omission or transaction taking place on or before the Effective Date." The court pointed out that "this is not a matter of factors and prongs." It also stated that nondebtor releases had not been approved by other courts "absent the finding of circumstances that may be characterized as unique." Courts had approved non-consensual third-party releases when (a) the estate received substantial consideration; (b)the enjoined claims were "channeled" to a settlement fund rather than extinguished; (c) the enjoined claims would indirectly impact the debtor's reorganization "by way of indemnity or contribution;" (d) and the plan otherwise provided for the full payment of the enjoined claims. The lower court did not make sufficient factual findings to support approval of the releases here. No inquiry was made and no evidence was presented that the releases were important to the plan and that the breadth of them were necessary to the plan. The only justification by the lower court for allowing the third-party releases was because the trust's contribution was "a material contribution to the estate." That was insufficient.

In re Sabine Oil & Gas Corp., 555 B.R. 180 (Bankr. S.D.N.Y. 2016), *appeal dsm. as moot sub nom, Official Comm. Of Unsec. Creditors v. Sabine Oil& Gas Corp. (In re Sabine Oils & Gas Corp.),* No. 16 Civ. 6054, 2017 WL 477790 (S.D.N.Y. Feb. 3, 2017). The debtors' bankruptcy plan included non-consensual third-party releases. The court stated that it had subject matter jurisdiction to release direct third-party claims because of released parties' indemnification rights against the Debtors' estates arising from a credit agreement. Citing to *Metromedia* and "other applicable law," the court approved the releases because they provided a substantial contribution to debtors' estates in the form of a number of concessions negotiated as part of the settlement and the plan, which provided value to

creditors who would otherwise receive minimal to no value in the absence of the settlement. The correct inquiry was "whether the Debtors' estates have received consideration," not "whether the holders of the released claims received consideration." The releases enjoined claims that would likely impact the reorganization through indemnity obligations, even though indemnity claims had not yet been asserted. The releases were an important part of the debtors' reorganization plan since it was because of the releases that the released parties agreed to negotiate with the debtors. The releases represented a portion of a deal that was inextricably intertwined with a settlement.

Gillman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203 (3d Cir. 2000). The court identified certain hallmarks of non-consensual third-party releases, *i.e.,* fairness, necessity to the reorganization and specific factual findings to support these conclusions. Because those factors were not present, it did not "speculate upon whether there are circumstances under which we might validate a nonconsensual release that is both necessary and given in exchange for fair consideration."

Opt-Out Lenders v. Millenium Lab Holdings II, LLC (In re Millenium Lab Holdings, II, LLC), Bankr. Case No. 15–12284–LSS, Civ. No. 16–110–LPS, 2017 WL 1032992 (D. Del. March 20, 2017). The confirmed plan released "a non-debtor, third-party's direct, non-bankruptcy, common law fraud and RICO claims against non-debtor equity holders." The plan provided no ability for third-parties to opt-out of the release and the plan enjoined third-parties from bringing or prosecuting claims released in the plan. The district court denied a motion to dismiss the appeal as equitably moot, finding that it could not consider that motion without deciding whether a constitutional defect prevented the bankruptcy court from the power to issue its decision. The district court was not convinced that the bankruptcy court ever had the opportunity to hear and rule on the adjudicatory authority issue, so it remanded the matter to the bankruptcy court to "consider whether, or clarify its ruling that, the Bankruptcy Court had constitutional adjudicatory authority" to approve the release. The court commented on the parties' positions, stating that the third-parties appeared to be entitled to Article III adjudication of the claims under *Stern v. Marshall*, 131 S.Ct. 2594 (2011). The court stated that it was persuaded by the third-parties' arguments that the release set forth in the plan was "tantamount to resolution of those claims on the merits against [a]ppellants." Any constitutional infirmity could not be cured by a *de novo* review by the district court because the actions released by the plan had not been adjudicated on the merits.

In re Abeinsa Holdings, Inc., 562 B.R. 265 (Bankr. D. Del. 2016). The debtors' Chapter 11 reorganization plan included broad releases of *claims of the debtors* against non-debtor third parties. Applying the *Master Mortgage* factors (set forth in the case summary below), the court held that the releases would be approved as valid exercise of the debtors' business judgment, and as being fair, reasonable and in best interests of the debtors' jointly administered Chapter 11 estates. There would be little to no recovery for unsecured creditors without the agreement by equity holders (the released parties) to fund a new value contribution that was dependent on the releases, and the releases, which were the result of extensive negotiations and arm's length bargaining, had overwhelming creditor support. The plan provided that a separate release by creditors of claims against third-parties applied if the creditor voted to accept the plan and unless the Chapter 11 ballot was

marked to indicate refusal to grant the release. The court stated that the third-party releases were designed to apply only to parties who affirmatively consented. Accordingly, they were fair and equitable.

National Heritage Found., Inc. v. Highbourne Found., 760 F.3d 344 (4th Cir. 2014). Proposed third-party releases in the chapter 11 plan of a non-profit charitable organization protected officers and directors with whom the debtor shared an identity of interest based on their indemnity claims against the debtor. Donors to the organization objected. The court examined the factors set forth in *Dow Corning* (set forth in the case summary below). Exceptional circumstances did not exist since only one factor suggested such circumstances: that the debtor's obligation to advance legal expenses and indemnify its officers and directors created an "identity of interest" between the debtor and the parties being released. The other factors did not suggest exceptional circumstances. The officers and directors did not make a substantial contribution to the reorganization. Instead, the officers continued to work for the debtor and were paid for their work and the directors had a fiduciary obligation to continue to work for the debtor. The argument that the officers and directors would leave the debtor's employment without the releases (thus making the releases necessary to the reorganization) was speculation. The class most affected by the releases did not have the opportunity to accept or reject the plan, there was no means for payment of the objecting class which was most affected by the releases, and there was no means for the objecting parties to recover outside the plan.

In re City Homes III LLC, 564 B.R. 827 (Bankr. D. Md. 2017). A Chapter 11 plan's proposed third-party releases of the claims of tenants of a corporate debtor and its affiliates, who were potentially poisoned by exposure to lead paint but whose claims were likely not covered by the debtors' liability insurance, would not be approved. The court cited to the *Dow Corning* factors (set forth in the case summary below) as applied in *National Heritage Foundation*. The uninsured claimants were not treated equally by the plan, were not represented by counsel, and likely had no actual knowledge of the trap set for their legal rights. The debtors were prepared to liquidate their assets before they sought bankruptcy counsel. Accordingly, it seemed that the Chapter 11 reorganization was only about positioning the case so releases could be secured for individuals who were not in bankruptcy. This was not consistent with the fiduciary obligations of either the estate or the professionals charged with safeguarding the best interests of all creditors. In addition, the class impacted by the releases did not vote overwhelmingly in favor of the releases. The uninsured claimants were not being paid all, or substantially all, of their claims under the plan, and the plan did not provide an opportunity for the uninsured claimants to recover in full outside of the plan. The court also cited to additional circumstances that justified the rejection of the releases.

In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002), *rejected on other grounds*, *In re PTI Holding Corp.*, 346 B.R. 820 (Bankr. D. Nev. 2006). The Chapter11 plan of a debtor manufacturer contained a provision barring claimants allegedly injured by the debtor's products from asserting claims against the debtor's corporate parents, Australian subsidiaries, affiliates, or settling insurers. The court stated that provided certain factors are present that reflect a finding of "unusual circumstances," the Bankruptcy Code does not

explicitly prohibit a bankruptcy court from issuing or enforcing a third party release to facilitate a reorganization plan:

The court set forth factors for determining whether there exist "unusual circumstances" meriting a third party release:

> (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
> (2) The non-debtor has contributed substantial assets to the reorganization;
> (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
> (4) The impacted class, or classes, has overwhelmingly voted to accept the plan;
> (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
> (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and;
> (7) The bankruptcy court made a record of specific factual findings that support its conclusions.

The Sixth Circuit remanded the matter for the bankruptcy court to determine whether the release was valid because the record consisted only of conclusory statements. There was no discussion of the evidence underling these statements, and the findings did not discuss the facts as they pertained to each released party. The releases were ultimately approved on remand.

In re Airadigm Commc'ns, Inc., 519 F.3d 640 (7th Cir. 2008). A non-consensual release in a Chapter 11 debtor's reorganization plan that would limit the liability (except for willful misconduct) of a third-party financier of the debtor "in connection with" the reorganization was within the bankruptcy court's powers. The court specified that the appropriateness of a release is a fact intensive question. The release must be necessary for the reorganization and appropriately tailored, which was the case here. The court stated that "[g]iven how narrow the limitation is and how essential [the financier] was for the reorganization, the release is 'appropriate' and thus within the bankruptcy court's powers." The release by its terms was narrow as it applied only to claims "arising out of or in connection with" the reorganization itself and it did not include willful misconduct. The release did not grant "blanket immunity" for all times, all transgressions, or all omissions, and it did not affect matters beyond the bankruptcy court's jurisdiction or unrelated to the reorganization. In addition, the limitation of liability in the release was subject to the plan's other provisions. There also existed "adequate" evidence that the financier required this limitation before it would provide the requisite financing, which was essential to the reorganization. Without the involvement of the financier, the debtor would be responsible for hundreds of millions of dollars in debt.

In re Ingersoll, Inc., 562 F.3d 856 (7th Cir. 2009). The court affirmed the approval of a release of the debtor's former owners arising from or related to two specific cases (one of which was a derivative action against the debtors). Citing to *Aradigm*, the court said that the release was "narrowly tailored and critical to the plan as a whole." The release did not cover all actions. Instead, it covered a narrow set of claims. Consideration was exchanged for the release (enabling unsecured creditors to receive a distribution), it was an essential part of the reorganization, and it arose after long-term negotiations. Under the unique circumstances of this case, the release was still valid although it shielded non-debtors from suits by non-creditors (rather than creditors).

OPS3 LLC, v. American Chartered Bank, NO. 13-cv-04398, 2017 WL 3263484 (N.D. Ill. August 1, 2017). Each confirmed Chapter 11 plan of four jointly administered debtors had a provision stating that all guaranties of any of the debtors of the other debtors' obligations would be deemed cancelled and that "any obligation of any of the Debtors and all guaranties by or on behalf of any of the Debtors shall be merged into the obligation of the Debtor as stated in the Plan." The district court affirmed the bankruptcy court's decision dismissing a count of a complaint seeking a declaration that certain guaranties had been merged into the obligations of the debtors and then discharged in bankruptcy. Even if the plain language of the plans purported to release the guaranties, the releases would not be acceptable under Seventh Circuit precedent. Citing to *Airadigm* and *Ingersoll*, the court examined whether the "provision is appropriately tailored and essential to the reorganization plan as a whole." Here, the language of the plans was not narrow as "all guaranties by or on behalf of any of the Debtors" would be released. In fact, the release could discharge unidentified guarantors. Although the participation by the released parties was essential to the reorganization, there were no allegations that such participation was induced by the releases or that the ability of the released parties to contribute to the reorganized company was dependent on the releases. Lastly, the bankruptcy court disclaimed the idea that it had signed off on the releases as part of the debtors' bankruptcy plans.

In re Master Mortgage Inv. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994). The Eighth Circuit has not addressed the issue directly of whether non-consensual third-party releases are valid. This Western District of Missouri case endorses the majority view and is often cited for the factors set forth in it of determining a release's validity:

> (1) There is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate.
> (2) The non-debtor has contributed substantial assets to the reorganization.
> (3) The injunction is essential to reorganization. Without the it, there is little likelihood of success.
> (4) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment.
> (5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

In this case, exceptional circumstances existed for issuance of third-party releases enjoining creditor action against non-debtor third-parties where the third-parties contributed financially to the reorganization in exchange for the injunctions, the injunctions were essential to the settlement, and the settlement was essential to the reorganization. In addition, the plan was overwhelmingly supported by creditors and the third-parties had a right of indemnification against the debtor. Likewise, the Chapter 11 plan proposed to pay in full all impaired claims.

In re Seaside Eng'g & Surveying, Inc, 780 F.3d 1070 (11th Cir. 2015). Against the opposition of outside equity holders in a closely held civil engineering and surveying firm, third-party releases/bar orders (referred to going forward as releases) were valid . The court stressed the fact that such releases are only appropriate in rare and unusual circumstances. The bankruptcy court made thorough factual findings using the *Dow Corning* factors. The releases were valid because they included former principal of the debtor who were professional surveyors and engineers and would be key employees of the reorganized debtor. If those parties had to defend future litigation, they would spend their time on that defense instead of focusing on their professional duties. In addition, the contribution by the third-parties (their services) was necessary to the reorganized entity. Without the releases, the litigation would continue and would ruin the chance of any reorganization. Other than the objectors and two other parties, all other classes had accepted the plan and the equity holders would be paid in full for the value of their interest. The releases were fair and equitable, and the scope of them was limited to the claims arising out of the Chapter 11 case. The court acknowledged its prior precedent approving a release of claims against a non-debtor in *In re Munford,* 97 F.3d 449 (11th Cir. 1996), and referred to *Munford* as "controlling precedent," but it pointed out that *Munford* presented facts different from those in this case. *Munford* involved a bar order providing that non-settling defendants in an adversary proceeding were enjoined from seeking recovery against a settling defendant. "[H]ere the releases prevent claims against non-debtors that would undermine the operations of, and doom the possibility of success for, the reorganized entity, ..."

In re HWA Props., Inc., 544 B.R. 231 (Bankr. M.D. Fla. 2016). Citing to *Seaside Eng'g & Surveying, Inc.* and applying the *Dow Corning* factors, the court held that a provision in a corporate debtor's proposed Chapter 11 plan preventing creditors from pursuing claims against the debtor's shareholders and other affiliated entities, was neither necessary to the debtor's successful reorganization nor fair and equitable. The plan could not be confirmed. The plan provided for assets of the estate to be transferred to one of debtor's creditors or to other entities controlled by the shareholders, *i.e.,* the debtor would emerge from bankruptcy without assets. Therefore, litigation against the shareholders and affiliated entities would have no impact on the estate. The parties benefitted by the bar order proposed in the plan had not made a substantial contribution to the debtor's reorganization where their contributions did not inure to the debtor's benefit and the debtor was not reorganizing. The entities that would be affected by the releases and bar order did not support the plan, would receive nothing under the plan, and were not afforded an opportunity to recover in full.

In re AOV Indus., 792 F.2d 1140 (D.C. Cir. 1986). The court did not rule on the issue of whether third-party releases in chapter 11 plans are valid, but it indicted a willingness to allow third-party releases when certain circumstances exist.

Case Law Examples - minority view

Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.), 584 F.3d 229 (5th Cir. 2009). The proposed Chapter 11 plan would "release [ ] [owners and guarantors] from liability ... related to proposing, implementing, and administering the [reorganization] plan." The court held that bankruptcy courts do not have the authority to issue and enforce third-party releases in Chapter 11 plans. The court cited to language in § 524(e) stating that "discharge of a debt of the debtor does not affect the liability of any other entity on … such debt." It pointed out that courts in the Fifth Circuit have held that § 524(e) only releases the debtor, not third-parties who are also liable, and from that precedent it concluded that nonconsensual, third-party releases and permanent injunctions are foreclosed. The court also noted that the Bankruptcy Code (11 U.S.C.A. § 524(g)) now permits bankruptcy courts to enjoin third-party asbestos claims under certain circumstances, which suggests that third-party releases are most appropriate as a method to channel mass claims toward a specific pool of assets.

Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394 (9th Cir. 1995). The court held that the Bankruptcy Code does not provide the court with authority to issue and enforce third-party releases in a Chapter 11 plan. The court stated that a bankruptcy court lacks the power to confirm plans of reorganization, which do not comply with the applicable provisions of the Bankruptcy Code. Citing to § 524(e), the court held that a discharge under Chapter 11 releases the debtor from personal liability for debts but does not release third-parties from liability. The court also stated that it has repeatedly held that § 524(e) precludes bankruptcy courts from discharging the liabilities of third-parties since that section displaces the court's equitable powers under § 105(a) to order the permanent relief against a third-party.

Landsing Diversified Prop.-II v. The First Nat'l Bank and Trust Co. of Oklahoma (In re Western Real Estate Fund, Inc.), 922 F.2d 592 (10th Cir. 1990), *opinion modified on other grounds,* 932 F.2d 898 (10th Cir. 1991). Courts do not have authority to issue and enforce third-party releases in Chapter 11 plans. The court cited to the language in § 524(e) and stated that the benefits of the bankruptcy process do not extend to non-debtors. The court concluded that it would "follow the Ninth Circuit's lead in *In re American Hardwoods, Inc.*, 885 F.2d at 621 and hold that while a temporary stay prohibiting a creditor's suit against a nondebtor during the bankruptcy proceeding may be permissible to facilitate the reorganization process in accord with the broad approach to nondebtor stays under section 105(a) . . . outlined above, the stay may not be extended post-confirmation in the form of a permanent injunction that effectively relieves the nondebtor from its own liability to the creditor."