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# 2017 Central States Bankruptcy Workshop

*Consumer Track*

# Chapter 7 Issues and Hot Topics


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# CHAPTER 7 HOT TOPICS:

# IMPORTANT EXEMPTION CASES POST-*LAW v. SIEGEL*

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## IMPORTANT EXEMPTION CASES POST-*LAW v. SIEGEL*

*Sixth Circuit Court of Appeals and Bankruptcy Courts:*

1. Short Sale – *In re Brown*, 851 F.3d 619 (6th Cir. 2017).

The trustee sought permission to sell the debtor's home, which was valued at $170,000 and subject to $219,000 in secured mortgage claims. The debtor did not claim an exemption in the property or Michigan redemption rights, but objected to the sale and sought to amend her Schedule C to claim exemptions in her redemption rights of $11,475 under 11 U.S.C. § 522(d)(1) and $11,675 under § 522(d)(5). The bankruptcy court permitted the sale and denied the exemption claim. The district court affirmed the bankruptcy court.

*Held*: The Sixth Circuit affirmed the bankruptcy court, holding that any exemption on the basis of the debtor's redemption rights must attach to some equity held by the debtor after satisfaction of the mortgage claims. "Absent such equity, the debtor had no interest to which a claimed exemption could attach." *Id*. at 624 (citing *In re Baldridge*, 553 F. App'x 598 (6th Cir. 2014). The court explained that *Law v. Siegel*, __ U.S. __, 134 S. Ct. 1188 (2014), was "not relevant" to its analysis: "Whereas *Law* addressed the extent of the bankruptcy court's discretionary powers under § 105(a), this case addresses the bankruptcy court's interpretation of a specific provision of the Bankruptcy Code [namely § 522(d)]. . . . *Law* does not strip bankruptcy courts of their ability to interpret the Bankruptcy Code; it merely reinforces the common-sense notion that bankruptcy courts may not use their discretionary powers to reach results that are inconsistent with the *clear* meaning of the Bankruptcy Code." *Id*. at 625.

2. Objection to Trustee's Final Report – *In re Holley*, 661 F. App'x 391 (6th Cir. Oct. 25, 2016) (unpublished opinion).

The trustee sold the debtors' residence, in which they claimed a Michigan tenancy by the entireties exemption. After the debtors initially objected to the sale, they reached an agreement with the trustee to sell to a buyer selected by the debtors at a reduced price so that they could retain the property. The trustee filed her final report proposing to pay the secured creditors and administrative claims of $97,734.32. The debtors objected, contending that the sale proceeds could not be used to pay administrative expenses because they were exempt under Michigan entireties law. The bankruptcy court denied the debtors' objections to the final report and their motion for reconsideration of the sale orders. The district court affirmed.

*Held*: The Sixth Circuit vacated the bankruptcy court's orders to the extent they permitted payment of the trustee's administrative fees. Even though the debtors filed multiple amendments which impeded the bankruptcy process, the bankruptcy court "could not lawfully award any of the exempt [p]roperty's equity to pay the [t]rustee's fees." *Id*. at 396 (citing *Law v. Siegel*, 134 S. Ct. at 1195). Section 522(k) "prohibits a bankruptcy court from charging exempt property for administrative expenses [subject to certain exceptions], even where a debtor has engaged in misconduct." *Id*. (citing *Law v. Siegel*, 134 S. Ct. at 1195-96). The court also indicated that under Michigan's entireties exemption, the entire value of the property, less amounts owed to joint creditors, was exempt.

3. Amending Schedule C – *In re Baker*, 791 F.3d 677 (6th Cir. 2015).

After the debtors' chapter 7 case was closed, it was reopened at the trustee's request to administer a non-disclosed cause of action. The debtors amended their Schedule C whereby each debtor claimed an exemption of $5,300 in the cause of action under 11 U.S.C. § 522(d)(5). The bankruptcy court overruled the trustee's objection and the district court affirmed.

*Held*: The Sixth Circuit also affirmed, holding that: "it is clear that *Siegel* prohibits the bankruptcy court from disallowing the debtors' claimed exemptions because of their alleged bad faith and fraudulent conduct. While *Lucius* [*v. McLemore*, 741 F.2d 125 (6th Cir. 1984)] previously held that bankruptcy courts may use their equitable powers to sanction a debtor's misconduct by disallowing exemptions in property concealed from the trustee, the Supreme Court's superseding decision unambiguously abrogates their ability to do so." *Id*. at 682. The court further reasoned that "*Siegel* also applies to cases that have been reopened, like this one." *Id*. at 683. Finally, the court concluded that the trustee waived his argument that, under Rule 1009(a), debtors in a reopened case may not amend as a matter of course because the trustee did not raise this argument within thirty days of the filing of the amended claim of exemption.

*Tenth Circuit Court of Appeals:*

1. Avoiding Judicial Lien Due to Impairment of Exemption -- *In re Grant*, 658 F. App'x 411 (10th Cir. Sept. 20, 2016) (unpublished opinion), *cert. denied sub nom. Clabaugh v. Grant*, 137 S. Ct. 1095, 197 L. Ed. 2d 182 (2017).

The debtor falsely told the bank he was the personal representative of Ms. Clabaugh's father's estate, and took possession of a safe deposit box containing coins and heirlooms worth as much as $2 million. He sold them for $488.00. Clabaugh sued the bank and the debtor, and obtained a $1.25 million dollar conversion judgment against the debtor. Clabaugh recorded the judgment, which under state law attached a judicial lien on the debtor's real property, including his residence. The debtor then filed for chapter 7 relief and filed a motion under 11 U.S.C.

§ 522(f)(1)(A) to avoid Clabaugh's judicial lien on his home because it impaired his homestead exemption. The bankruptcy court granted the debtor's motion and the BAP affirmed.

*Held*: The Tenth Circuit also affirmed, rejecting Clabaugh's argument that, under *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365, 127 S. Ct. 1105 (2007), the bankruptcy court had the equitable power to deny the debtor's right to avoid the judgment lien because the debtor was dishonest and concealed his assets from the court. "[A]s both the bankruptcy court and the BAP explained here, the Supreme Court's decision in *Law v. Siegel*, __ U.S. __, 134 S. Ct. 1188, 188 L.Ed.2d (2014), refined *Marrama's* holding, and unanimously rejected" the arguments raised by Clabaugh. *Id*. at 414. "*Siegel* held the Bankruptcy Code does not confer 'a general, equitable power in bankruptcy courts to deny exemptions based on a debtor's bad-faith conduct.'" *Id*. (citing *Law v. Siegel*, 134 S. Ct. at 1196-97) ("*Marrama* most certainly did not endorse, even in dictum, the view that equitable considerations permit a bankruptcy court to contravene express provisions of the [Bankruptcy] Code."). The court concluded that, no matter how persuasive Clabaugh's equitable arguments might be, "under *Siegel*, the bankruptcy court could not exercise its equitable powers to deny [the debtor's] § 522(f)(1)(A) avoidance motion because there is no statutory basis to do so." *Id*. at 415.

<u>*Ninth Circuit Court of Appeals, B.A.P, and Bankruptcy Courts:*</u>

1. <u>State Law Grounds for Objecting to Exemptions</u> – *In re Lua*, 551 B.R. 448 (C.D. Cal. 2015), *appeal docketed*, Case No. 15-56814 (9th Cir. Nov. 25, 2015) (argued Apr. 6, 2017).

The debtor filed amended schedules indicating that the property she resided in belonged to her husband and that her only interest in the property was "such community interest as may exist for the purposes of a divorce action." She also removed her homestead exemption and changed it to a wild-card exemption of other assets under California law. The trustee determined that the debtor did have an interest in the property that could be monetized. After failed negotiations, the bankruptcy court ordered the debtor and her husband to turn the property over to the trustee. The husband settled with the trustee and agreed to certain terms regarding the sale of the property, but the debtor did not cooperate with the trustee's sale efforts. Three years after the case was filed, the Debtor amended her schedules again and claimed a homestead exemption of $100,000 in the property. The trustee objected, asserting bad faith, estoppel, and laches as equitable grounds for disallowing the homestead exemption. The bankruptcy court sustained the trustee's objection on state law equitable estoppel grounds.

*Held*: The district court affirmed, explaining that "[b]ankruptcy courts may disallow exemptions on state law grounds." *Id*. at 452 (citing *Law v. Siegel,* __ U.S. __, 134 S. Ct. 1188, 1196–97, (2014) ("It is of course true that when a debtor claims a *state-created* exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption."); *In re Gray,* 523 B.R. 170, 175 (9th Cir. B.A.P. 2014) (remanding for the bankruptcy court to consider whether Arizona equitable considerations could be used to deny an exemption). In this case, the debtor did not challenge the bankruptcy court's determination that equitable doctrines such as estoppel applied to claims of exemptions under California law, but rather argued that the bankruptcy court incorrectly applied the elements of equitable estoppel to the facts of the case. The district court disagreed with the debtor's assertion. The court concluded that it could not be disputed that the debtor "did not deal fairly with the trustee" and that her last minute amendment to exemptions was an attempt to "nullify" the trustee's "significant efforts" to sell the property and "to reap a windfall for herself" and her husband. Because the elements of equitable estoppel were satisfied, the bankruptcy court properly denied the debtor's amended homestead exemption.

2. State Law Grounds for Objecting to Exemptions and Burden of Proof – *In re Aubry*, 558 B.R. 333 (Bankr. C.D. Cal. 2016).

On second amended schedules filed nearly two years after the debtor's bankruptcy petition, the debtor disclosed an interest in an annuity under which the debtor received payments of over $8,000 per year. The debtor also claimed an exemption in the annuity under California law.

*Held*: Following *Lua*, the bankruptcy court determined the debtor's late-claimed exemption in the annuity should be disallowed. Although the court found that the debtor was entitled to claim the annuity as exempt under the applicable California statute, it concluded that the debtor should be equitably estopped from doing so. The court explained that "when a debtor claims a *state-created* exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption." *Id*. at 345 (citing *Law v. Siegel*, __ U.S. __, 134 S. Ct. 1188, 1196–1197 (2014) (emphasis in original) and *In re Lua,* 529 B.R. 766, 774 (Bankr. C.D. Cal. 2015), *affirmed,* 551 B.R. 448, 452 (C.D. Cal. 2015), *appeal pending,* No. 15–56814 (9th Cir., notice of appeal filed on November 24, 2015)).

The court also noted that under Rule 4003(c), the burden of proof is on the objecting party to prove that the exemptions are not properly claimed, while under California law the "exemption claimant has the burden of proof." The court observed that there was no controlling Ninth Circuit law on which burden to apply. However, the court ultimately determined that it need not decide the issue because under the state law burden, the debtor had proven a prima facie entitlement to the exemption, and under Rule 4003(c), the trustee had not met his burden of establishing that the debtor was not entitled to claim the exemption under the California statute.

3. Burden of Proof – *In re Diaz*, 547 B.R. 329 (9th Cir. B.A.P. 2016).

After the trustee moved for turnover of the debtor's real property, the debtor amended his schedules to claim the California homestead exemption. The trustee objected on the basis that the debtor was not living at the property as of the date of the filing of the bankruptcy case. The debtor responded, explaining that he had multiple, serious medical problems that rendered him unable to live independently in the residence. The debtor further stated that his medical condition was improving and that he was moving back to the property on a full time basis. The bankruptcy court sustained the trustee's objection. The BAP reversed and remanded because the record was not clear as to whether the debtor intended to make the property his residence. The BAP also determined that Rule 4003 does not abrogate the burden of proof set forth in a state law exemption statute. The BAP concluded that "where a state law exemption statute specifically allocates the burden of proof to the debtor, Rule 4003(c) does not change that allocation." *Id*. at 337.

*Cases Addressing Bankruptcy Rule 4003(b)(2):*

1. *In re Woolner*, 2014 WL 7184042 (Bankr. E.D. Mich. Dec. 15, 2014) (unpublished opinion).

The debtors timely amended their Schedule C to claim exemptions under 11 U.S.C. § 522(d)(5) in a 1990 Corvette and 2013 tax refunds. The trustee timely objected alleging that the debtors intentionally undervalued the assets in bad faith. The trustee relied on Rule 4003(b)(2) which provides: "The trustee may file an objection to a claim of exemption at any time prior to one year after the closing of the case if the debtor fraudulently asserted the claim of exemption . . . ."

*Held*: Citing the history of Rule 4003(b)(2), including the Advisory Committee Notes, the bankruptcy court denied the claim of exemption. The court reasoned that courts should be able to presume that a procedural rule is based upon the court's authority to rule on the substantive issue raised in accordance with the procedure set forth in the rule, and that *Law v. Siegel* should not render the rule meaningless by implication.

NOTE: *Woolner* was likely overruled by implication by the Sixth Circuit's decision in *Ellman v. Baker*, cited above.

2. *In re Bogan*, 534 B.R. 346 (Bankr. W.D. Wis. 2015).

On the debtor's motion, the court reopened the chapter 7 case and the debtor amended her Schedule C to claim an exemption in life insurance policy benefits. The trustee objected, arguing the amendment was made in bad faith.

*Held*: The bankruptcy court overruled the trustee's objection. The court explained that neither Rule 4003(b)(2), nor any other rule, could create, alter, or amend substantive rights. Accordingly, the court held that "[i]f Congress wanted to give bankruptcy courts the power to deny bad faith exemption amendments, then it would have added a provision to § 522." *Id*. at 349. Citing *Law v. Siegel*, the court noted that Supreme Court dicta is not to be taken lightly and that the bankruptcy court is without federal authority to disallow exemptions based on bad faith.

**What to do with a LLC membership interest in bankruptcy**

You are or represent a Chapter 7 bankruptcy trustee and one of the debtor's disclosed assets on her schedules is an interest in a limited liability company (LLC). While administering the LLC membership interest may be more challenging than administering physical assets, LLC membership interests can be very valuable assets that generate substantial income for a bankruptcy estate. This discussion provides useful guidance in administering and liquidating a LLC membership interest in bankruptcy.

The first step is to read and understand the operative LLC documents, such as the operating agreement or membership agreement. Is the LLC member or manager managed? What law governs the LLC? This is important because while many states have adopted the Uniform Limited Liability Company Act, not all states have adopted the Act and even those that have adopted the Act have modified it. What powers does a member have under applicable state law? Does it include the power to seek dissolution or otherwise windup the affairs of the LLC?

The next step is to determine how the LLC membership interest is held. For example, under Michigan law, a LLC membership interest is personal property and may be held in any manner that personal property may be held, including being held by husband and wife. MCL § 450.4504. Is the membership interest held as tenants by the entirety? Finally, you need to get your arms around the operations of the LLC and its assets and liabilities. Once you fully understand the lay of the land, get ready for some interesting legal issues.

**Dissociation from a LLC**

Many states permit disassociation provisions in LLC operating agreements that remove a member from a LLC under certain circumstances. Michigan contains the following statutory provision:

> (2) An operating agreement may provide for the expulsion of a member or for other events the occurrence of which will result in a person ceasing to be a member of the limited liability company.

MCL § 450.4509(2). Many LLC operating agreements include provisions that dissociate a member after she files for bankruptcy. Is this permissible under the Bankruptcy Code?

Section 541(c)(1) states that an interest of the debtor becomes property of the bankruptcy estate notwithstanding any agreement or applicable non-bankruptcy law that purports to restrict the transfer or is conditioned upon the commencement of a bankruptcy case. Thus, *ipso facto* clauses are invalidated by the Bankruptcy Code. Bankruptcy courts addressing the issue of whether dissociation provisions are enforceable tend to hold that dissociation is pre-empted by § 541(c). *See In re Ellis*, 2011 Bankr. LEXIS 4169, at *5 (U.S. Bankr. S.D. Ind. Oct. 27, 2011) ("[Dissociation] provisions fall squarely under § 541(c)(1), and therefore § 541(c)(1) 'trumps' the provisions of the Illinois Limited Liability Act which terminate a member's non economic interest in the LLC upon the filing of the member's bankruptcy."); *Klingerman v. ExecuCorp, LLC (In re Klingerman)*, 388 B.R. 677, 679 (Bankr. E.D.N.C. 2008) ("Converting a debtor's membership interest to that of an assignee by operation of statute is a modification or termination of the interest that is rendered ineffective by § 541(c)."); *but see, In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 709 (Bankr. E.D. Va. 2000) (holding that disassociation was permissible to remove debtor's management rights from the estate).

However, there are situations where a trustee might want to rely on the language of the operating agreement stating that a member is disassociated. Suppose that an operating agreement contains a dissociation provision and also states that the disassociating member's membership interest must be purchased at market value by the other members within 30 days after disassociation. This may be a situation where the roles are reversed and the Trustee relies on the dissociation provision to liquidate the asset while the other members argue that the dissociation language is void under § 541(c).

**What comes into the bankruptcy estate?**

While the Bankruptcy Code does not mention LLCs, it is clear that an individual debtor's membership interest in a LLC becomes property of the bankruptcy estate once a petition is filed. *See* 11 U.S.C. § 541(a) (stating that a bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case"); *Chartschlaa v. Nationwide Mut. Ins. Co*., 538 F.3d 116, 122 (2nd Cir. 2008) ("Every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, is within the reach of § 541.").

Generally speaking, economic rights are the rights to receive LLC distributions. Non-economic rights are the rights to participate in management and operation of the LLC. The economic rights of the member become property of the bankruptcy estate. *See In re Garrison-Ashburn, L.C.,* 253 B.R. 700, 707 (Bankr. E.D. Va. 2000) ("There is no question that the economic rights, that is the membership interest, becomes property of the estate.").

What about non-economic rights? Pre-petition, the bundle of rights possessed by the debtor included both the economic and non-economic rights. The majority of courts that have considered this issue hold that both the economic and non-economic rights enter the bankruptcy estate. *See Fursman v. Ulrich* (*In re First Prot., Inc.)*, 440 B.R. 821, 832 (B.A.P. 9th Cir. 2010) ("Debtors' membership interests and contractual rights under the operating agreement became property of their estate."); *In re Talbut*, 2015 Bankr. LEXIS 2882, at *8-9 (U.S. Bankr. N.D. Ohio Aug. 28, 2015) ("Both Debtor's economic and non-economic rights in the LLC became property of his bankruptcy estate."); *In re Zoll*, 2012 Bankr. LEXIS 342, at *8 n.3 (U.S. Bankr. N.D. Ill. Feb. 1, 2012) ("The estate therefore acquired both financial and management rights on the petition date, and Gierum could assign those rights to Restructure Capital."); *but see, In re Garrison-Ashburn, L.C*., *supra*. Accordingly, the trustee has an asset with two marketable components – economic and non-economic rights. Depending on the circumstances of the LLC, one or both of the components may be marketable.

**Issues Liquidating Membership Interests**

A single member LLC membership interest is often easier to liquidate than a multi-member LLC membership interest because members of a LLC tend to have strong opinions about who the other members are. Thus, restrictions in operating agreements may become a hotly contested issue when a bankruptcy trustee attempts to liquidate a multi-member LLC membership interest.

What if the operating agreement does not restrict or condition the property from coming into the bankruptcy estate, but places restrictions on how a membership interest is disposed of? Specifically, what about a right of first refusal in favor of the other LLC members? Such provisions have been upheld. *See Northrop Grumman Tech. Servs. v. Shaw Goup Inc. (In re IT Grp., Inc.)*, 302 B.R. 483, 488 (D. Del. 2003) ("Where, as here, the right of first refusal clause is not an *ipso facto* provision, courts have concluded that a right of first refusal is enforceable notwithstanding the fact that the debtor is in bankruptcy."); *In re Capital Acquisitions & Mgmt. Corp*., 341 B.R. 632, 638 (Bankr. N.D. Ill. 2006) ("The Receiver took CAMCO's property rights as it found them on the date of the petition. CAMCO's interest in Rainbow is subject to this right of first refusal, and that is how the Receiver must sell it."); *In re Talbut*, No. 08-34763, 2015 Bankr. LEXIS 2882, at *13-14 (U.S. Bankr. N.D. Ohio Aug. 28, 2015) ("Thus, § 363(l) does not excuse the Trustee from complying with the requirements of § 8.01 [of the operating agreement] in the process of selling Debtor's membership interest."). A trustee should carefully evaluate whether the restrictions are enforceable because failure to comply with enforceable restrictions may lead to objections to or invalidation of a proposed sale.

Another issue regarding liquidation of a LLC membership interest is valuation. Valuing a membership interest in a closely held LLC can be challenging, and issues can be compounded where a debtor has strong views on the value of her LLC membership interest or otherwise is acting as a roadblock to the trustee's administration of the estate. In a situation where a bankruptcy trustee knows that valuation will be a contested issue, the trustee should first obtain a valuation from a qualified expert/advisor before seeking to sell the LLC membership interest. A valuation will likely involve an understanding of the business of the LLC and its assets and liabilities. In addition, the valuation will involve various discounts for items such as characteristics of ownership, lack of control, or lack of marketability.

Lastly, trustees should be aware that there are third parties that specialize in the acquisition of LLC membership interests from bankruptcy estates. But, all of the issues discussed herein are relevant to a proposed disposition. For example, on certain occasions, the asset purchaser is interested only in the economic rights and not the non-economic rights. The trustee must carefully examine what to do with the non-economic rights if a sale is consummated. What happens if the trustee abandons the non-economic rights after consummation of the sale of the economic rights? Other issues involve enforcement of operating agreement restrictions by other members to restrict the acquisition by the asset purchaser. Practice point – members of a LLC that were previously uninterested in purchasing the debtor's membership interest often times become more interested in acquiring the debtor's membership interest when a third-party purchaser enters the mix.

**Are Operating Agreements Executory Contracts?**

First, you must determine what test applies in your jurisdiction with respect to executory contracts. The Sixth Circuit has adopted the following test, which is essentially the Countryman definition: "Congress intended the term to be defined as a contract 'on which performance remains due to some extent on both sides.' *In re Terrell*, 892 F.2d 469, 471 (6th Cir. 1989). The next step in the analysis is whether or not the LLC operating agreement qualifies as an executory contract.

This is a factual determination, but the determination is important. For example, assume the LLC requires supermajority approval to remove a manager and supermajority approval is not possible without the debtor's vote. Assume further that issues have arisen with respect to the removal of a manager. The presumed active participation requirement of the debtor's membership interest likely makes the operating agreement an executory contract. *See In re Strata, LLC,* 2013 Bankr. LEXIS 1704, at *13 (U.S. Bankr. D. Ariz. Apr. 25, 2013) ("If the Debtor or Santerra's other members do not timely and in good faith make these decisions required by the Operating Agreement, there will be a breach of the Operating Agreement. For these reasons, the Court concludes the Operating Agreement is an executory contract."). What if the trustee votes the debtor's membership interest in favor of terminating the manager and the manager then sues the LLC for wrongful termination?

There are other issues that may arise if an operating agreement is determined to be executory, such as § 365(c) and 365(e) issues. Under Section 365(c)(1), non-debtor parties can prevent a trustee from assuming and assigning a contract where substitute performance would not be permitted from another. Assume that your debtor is an attorney that holds a membership interest in a PLLC. Members of a PLLC must be licensed attorneys. *See* MCL § 450.4903. Is the trustee prevented from assuming that operating agreement or otherwise selling the membership interest? Similarly, Section 365(e)(2) allows non-debtor parties to enforce transfers restrictions contained in executory contracts against a trustee in certain circumstances and to excuse them from accepting or rendering performance to a trustee. Arguably, § 541(c)(1) conflicts with § 365(e)(2), but there is a difference between entry of the LLC membership interest into the bankruptcy estate and disposition of the LLC membership interest once it is in the bankruptcy estate.

What if the operating agreement is executory and the trustee fails to timely assume under 365(d)(1)? A: there are potential implications. Specifically, when "a contract is deemed rejected it constitutes a breach of contract, relieving a debtor from any future obligations and permitting the other party to the contract to file a claim." *Warner v. Warner*, 480 B.R. 641, 650 (Bankr. N.D.W. Va. 2012). Let's assume that there is a mandatory LLC membership purchase provision in the operating agreement that can be triggered by a member that is not in default of the operating agreement. Let's further assume that the LLC issued a capital call, the trustee did not meet the capital call, and the trustee did not timely assume the operating agreement. The trustee may have lost the ability to enforce the mandatory LLC membership purchase provision.

What if the Trustee expressly rejects the operating agreement? A: whatever rights the parties possess post-rejection are "governed by the terms of the contract and ordinary principles

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of state law." *BMA Ventures, LLC v. Prillaman (In re Minton*), Nos. 14-91293, 15-09033, 2017 Bankr. LEXIS 199, at *9 (U.S. Bankr. C.D. Ill. Jan. 23, 2017).

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# CHAPTER 7 HOT TOPICS:

## I. WAGE GARNISHMENT PREFERENCE CLAIMS

## II. CASE LAW DEVELOPMENTS POST-*HUSKY*

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## CHAPTER 7 HOT TOPICS:

### I. WAGE GARNISHMENT PREFERENCE CLAIMS

I. Transfers that are avoidable under § 547(b):

A. Any transfer of an interest of the debtor in property

1. To or for the benefit of a creditor,
2. For or on account of an antecedent debt owed by the debtor before such transfer was made,
3. Made while the debtor was insolvent,
4. Made
   (a) On or within 90 days before the date of the filing of the petition, and

5. That enables such creditor to receive more than such creditor would receive if
   (a) The case were a case under Chapter 7,
   (b) The transfer had not been made, and
   (c) Such creditor received payment of such debt to the extent provided by the provisions of this title.

II. Under § 547(e)(1)(B), "a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."

III. Under § 547(e)(2), "except as provided in paragraph (3) of this subsection, a transfer is made (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 30 days after, such time. . . ."

IV. But, subsection 547(e)(3) provides: "For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred."

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V. Sections 522(h) and (i) allow the Chapter 7 debtor to avoid and recover transfers under § 547 and § 550 if the trustee does not attempt to avoid the transfer, and further permit the debtor to exempt the property recovered under subsection 522(b).

VI. A key question that arises in the wage garnishment context is what transfers are avoidable as preferences, and the answer usually turns on when the transfer to the creditor occurs.

VII. How Wage Garnishments Work

A. In Wisconsin, an earnings garnishment form is served on the employer. If the employer expects to become liable to the debtor for wages earned in pay periods beginning within 13 weeks after the date of service, then up to 20% of the debtor's disposable earnings must be withheld and paid over to the creditor in satisfaction of the judgment. Wis. Stat. §§ 812.35(5), 812.34(2).
B. The debtor is entitled to file an answer or an amended answer claiming any defense or further exemptions at any time during the effective period of the garnishment. Wis. Stat. § 812.37(1).
C. If no answer, or if the debtor's answer is overruled, the employer is directed to pay to the creditor the portion of non-exempt earnings to which the creditor is entitled between 5 and 10 days after the pay date. Wis. Stat. § 812.39(1).

VIII. Continuing lien/lien vesting theory.

A. Under the lien vesting theory, the creditor has a lien in all future wages of the debtor from the time of the service of the garnishment writ. As of that date, the creditor has a perfected lien, so if the garnishment writ is served outside the 90 day preference period, no wages garnished are preferential, even if they are earned in the 90 day preference period. See *In re Coppie*, 728 F.2d 951 (7th Cir.1984).

B. To address the issue of 547(e)(3), some courts have held that the garnishment is a novation of the wages, so that the debtor never obtains an interest in them. *Id*. This reasoning has been roundly criticized, and *Collier's* simply calls that conclusion wrong.

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IX. Wage Vesting theory

A. Under the more widely adopted wage vesting theory, the garnishment lien attaches as wages are earned, and wages earned outside the 90 day preference period are not subject to avoidance even if they were actually paid over to the garnishing creditor within the 90 day preference period. See, e.g., *Deardorff v. Ford Motor Credit Co*. (*In re Deardorff*), 195 B.R. 904, 911 (Bankr. W.D. Wis. 1996)(Utschig, J.); *Weinman v. Alternate Revenue Systems, Inc*. (*In re Stevens*), 552 B.R. 773, 780 (Bankr. D. Colo. 2016). See also *In re Morehead*, 249 F.3d 445 (6th Cir. 2001)(reversing bankruptcy court decision under the lien vesting theory); *In re Jackson*, 850 F.3d 816, 821 (5th Cir. 2017)(decided March 13, 2017: "we hold that a creditor's collection of garnished wages *earned during the preference period* is an avoidable transfer" (emphasis added)).

X. Intersection of the small dollar preference defenses of 547(c)(8) and (9).

A. The interesting question here is that the exclusion of one or a portion of the payments can bring the amount of the transfers below the $600 minimum preference threshold ($6,425 for debtors whose debts are not primarily consumer debts). See *Pierce v. Collection Associates, Inc*. (*In re Pierce*), 779 F.3d 814 (8th Cir. 2015)(affirming the Bankruptcy Court and the Bankruptcy Appellate Panel, dismissing a consumer debtor's complaint under § 547(c)(8), holding that the court could not ignore the fact that the creditor received less than $600 in wage garnishments in the preference period because the final garnished amounts were not received by the creditor). See also *In re Jacobs,* 2014 WL 8186753 (E.D. Mich 2014)(Randon, J.). The court in *Jacobs* denied debtor's motion for turnover and sanctions: "Therefore, the critical date in determining whether garnished wages fall within the preference period *is not* when a creditor receives the garnished funds or perfects its garnishment lien—it is when a debtor *earns* the wages: garnished wages earned during the 90-day preference period are avoidable." *Id.* at *2 (emphasis in original). The motion was denied because the debtor could not prove that she earned more than $600 that was garnished during the preference period.

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## II. CASE LAW DEVELOPMENTS POST-*HUSKY*

I. *Husky International Electronics Inc. v. Ritz*, 136 S.Ct. 1581 (May 16, 2016)

A. *Husky* resolved the question of whether a false representation to the creditor was required to for a creditor to prevail on a non-dischargeability claim based on actual fraud under 11 U.S.C. § 523(a)(2)(A). The Supreme Court held that such a false representation was not required.

B. Section 523 provides:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by
>
> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition.

C. The Fifth Circuit had held below that actual fraud required a misrepresentation to the creditor.

D. Chrysalis owed Husky $164,000. Ritz, who owned at least 30% of Chrysalis stock, transferred at least $274,000 from Chrysalis to three other entities in which he held interests ranging from 25-100%. In 2009, Husky sued Ritz to hold him personally responsible for the $164,000 corporate debt, alleging that the inter-company transfer scheme was actual fraud sufficient to impose personal liability via a Texas statute on piercing the corporate veil. After Ritz filed a Chapter 7 petition, Husky brought a non-dischargeability claim based on actual fraud under § 523(a)(2)(A). The Fifth Circuit ruled Ritz did not commit actual fraud, holding that a misrepresentation was a necessary element.

E. The Supreme Court distinguished "inducement-based" frauds, such as those involving a misrepresentation of the debtor to the creditor that induced some detrimental reliance, from fraudulent transfer types of fraud that can be accomplished without any fraud (misrepresentation) at the inception of the

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transaction. The Supreme Court held that fraudulent transfer claims could still qualify as the "actual fraud" sufficient to support a non-dischargeability claim, and that no misrepresentation to the creditor was required.

F. However, the Supreme Court did not rule on other elements of the § 523(a)(2)(A) claim against Ritz, such as addressing how Ritz might have "obtained" money, property, or services as a result of the actual fraud. In fact, the Supreme Court expressly states that a non-dischargeability claim in the fraudulent transfer context would lie against the fraudulent transfer *transferee*, but not necessarily against the transferor. 136 S. Ct. at 1589. In other words, although a fraudulent transfer scheme might qualify as actual fraud even without a misrepresentation at the inception of the debt, Husky still has to show (in this author's opinion) that the debt was for money, property, or services obtained by that actual fraud. Ritz may be liable under the applicable Texas law as a shareholder for orchestrating or participating in the intercompany transfers, but § 523(a)(2)(A) would still seem to require a showing that the debt is for money or other property or services obtained by Ritz by virtue of the fraud.

G. The Supreme Court also addressed two other issues. First, it held that non-dischargeability claims under §§ 523(a)(2), (a)(4), and (a)(6) are not mutually exclusive—the same conduct might support a non-dischargeability claim under more than one subsection. Second, it rejected Ritz's suggestion that allowing § 523(a)(2)(A) claims based on fraudulent transfers would be redundant with the denial of discharge provision of § 727(a)(2).

II. Pre-Husky Cases—The Sixth and Seventh Circuits had already held that a misrepresentation was not necessarily required.

A. *McClellan v. Cantrell,* 217 F.3d 890 (7th Cir. 2000) The Seventh Circuit held that 523(a)(2)(A) did not reach constructive frauds, only actual ones. Therefore, a claim based on a constructively fraudulent transfer (a transfer for less than reasonably equivalent value) is not enough, there must be actual intent to defraud. But the court also held that a misrepresentation is not required. Facts: Debtor transferred equipment to his sister for nominal value in an effort to prevent collection by the creditor. The sister then sold the equipment for $160,000, and subsequently filed a chapter 7 case. The Seventh Circuit reversed the dismissal of the creditor's complaint so he could have the opportunity to prove actual fraud and have the sister's debt (as a fraudulent transfer transferee) declared non-dischargeable.

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B. *In re Vitanovich,* 259 B.R. 873 (6th Cir. BAP 2001). Check kiting scheme includes actual fraud, which is broader than misrepresentation and encompasses any deceit, artifice, trick or design. Citing *McClellan* favorably. Facts: Debtor engaged in a check kiting scheme, resulting in a net balance of $12,800 owed to the bank. "When a debtor intentionally engages in a scheme to deprive or cheat another of property or a legal right, that debtor has engage in actual fraud and is not entitled to the fresh start provided by the Bankruptcy Code."

III. Post-Husky Cases

A. *In re Cohn*, 561 B.R. 476 (Bankr. N.D. Ill. 2016)(Mollis, J., November 15, 2016). Creditor and Debtor formed a company to build a spec home. The home ended up costing much more than expected to build. Creditor's 523(a)(2), (a)(4) and (a)(6) claims were rejected after trial, as the court found the creditor had the burden to prove fraud, but that the debtor's actions appeared to be the product of mere incompetence. Citing *Husky* for the proposition that while "fraud connotes deception or trickery generally, the term is difficult to define more precisely."

*B.* *In re Korn*, 2017 WL 1379338, (Bankr. E.D. Mich. 2017)(Tucker, J., April 14, 2017). The court denied summary judgment to the plaintiff seeking to hold a debt non-dischargeable on a wide variety of theories, arising from a long and complicated business relationship between the parties. The court provided a thoughtful and clear analysis of *Husky*, and determined that justifiable reliance remained an element of proof for the plaintiff that seeks to establish actual fraud on an inducement-based fraud theory. Because justifiable reliance was not part of the case litigated in the underlying, pre-bankruptcy state court litigation, the plaintiff was not entitled to rely upon collateral estoppel to meet the reliance requirement, so summary judgment was denied.

C. *In re Meier*, 2016 WL 5942309 (Bankr. N.D. Ill 2016)(Schmetterer, J., October 12, 2016). Minority interest holder sued LLC managing member and majority owner for breach of fiduciary duty, breach of contract and other claims. After jury verdict for minority holder (including $110MM in punitive damages), majority owner filed a petition under Chapter 11, which was later converted to Chapter 7. Minority owner sought to have the debt declared non-dischargeable under §§ 523(a)(2)(A), (a)(4) and

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(a)(6). The case proceeded on summary judgment based on the creditor's argument that collateral estoppel based on the state court jury verdict established the non-dischargeability elements.

1. While citing *Husky* for the proposition that actual fraud can be effected without a false representation, the decision proceeded primarily on an inducement-based analysis, ultimately concluding that the jury finding of breach of fiduciary duty did not establish on a collateral estoppel basis the requisite level of intent to defraud the plaintiff to succeed under § 523(a)(2)(A).

2. Despite *Husky* and *McClellan*, the court stated that under § 523(a)(2)(A), a creditor must establish that (1) the debtor made a false representation of fact, (2) which the debtor (a) either knew to be false or made with reckless disregard for its truth and (b) made with an intent to deceive; and (3) the creditor justifiably relied on the false representation. *Id.* at *11. "All three elements must be established and failure to establish any one element is outcome determinative." *Id.*

3. For claims under an actual fraud theory, the court stated that to establish fraud, the creditor has to prove that (1) a fraud occurred, (2) the debtor intended to defraud the creditor, and (3) the fraud created the debt that is the subject of the dispute. However, the court then went on provide that all causes of action under 523(a)(2)(A)—false pretenses, false representation or actual fraud—required proof that the debtor acted with an intent to deceive, and further stated that the reliance element requires a showing that the debtor made a material misrepresentation that was the cause-in-fact of the debt that the creditor wants excepted from discharge. *Id.* at *11-12.

4. The court did hold the debt was non-dischargeable under § 523(a)(4) and § 523(a)(6), rejecting along the way the debtor's argument that those two subsections were mutually exclusive citing, among other cases, *Husky*.

D. *In re Thompson*, 555 B.R. 1 (10th Cir. BAP 2016)( August 19, 2016). Estate of nursing home resident sued owner of LLC that owned the home, based on alleged substandard care. Owner filed Chapter 7 on morning of

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trial. Estate brought non-dischargeability action under § 523(a)(2), under a corporate veil piercing theory based on fraud, and asserted that the fraud included numerous misrepresentations to the Department of Health in applications to obtain operating licenses. The BAP stated that the bankruptcy court first had determine the validity of the debt, and then had to determine the dischargeability of the debt. To establish actual fraud, the court stated that 523(a)(2)(A) requires the creditor to show three elements: (1) the debtor committed actual fraud; (2) the debtor obtained money, property, services, or credit by the actual fraud; and (3) the debt arises from the actual fraud. The court reversed the trial court's dismissal of the action, holding the creditor has alleged sufficient facts that might establish the requisite wrongful intent and conduct sufficiently imbued by deception or trickery to deprive of cheat another of property or a legal right. The court also held that there was no requirement that the debt owed be for something the debtor obtains from the creditor.

E. *In re Vanwinkle*, 562 B.R. 671 (Bankr. E.D. Ky. 2016)(December 27, 2016). The court dismissed an amended adversary complaint for failure to state a claim. The complaint sought to hold a debt non-dischargeable pursuant to §§ 523(a)(2)(A) and (a)(6). The creditor had obtained a state court judgment for the debtor's liabilities under the operating agreement of a jointly owned LLC, and then alleged that the debtor's post-judgment asset transfers and alleged fraudulent transfer scheme rendered the debt non-dischargeable. The court recognized that, based on *Husky*, a debt may be non-dischargeable based solely on actual fraud, without the need of a misrepresentation or misleading omission, but the court held that the purported non-dischargeable debt must be "obtained by" the actual fraud. 562 B.R. at 677. The creditor could not use § 523(a)(2)(A) to simultaneously create a debt and then render it non-dischargeable. 562 B.R. at 678. The case distinguishes *Husky* on the basis that Ritz (the debtor in *Husky*) was alleged to be liable under a veil-piercing statute and liability thereunder might be based on actual fraud. *Id*. at 677.

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IV. Pre-Husky case that gets it right.

A. *In re Lawson*, 791 F.3d 214 (1st Cir. 2015) Debtor knowingly colluded with her father to receive fraudulent transfers of money with the intent to defeat the rights of creditors of her father. This was sufficient to bar the claim from discharge. Creditor had judgment against Father for $168,000. Debtor was held liable for an $80,000 transfer to herself personally. A misrepresentation was not required.

KeyCite Yellow Flag - Negative Treatment
Disagreed With by In re Morehead, 6th Cir.(Ky.), May 3, 2001

728 F.2d 951
United States Court of Appeals, Seventh Circuit.

In the Matter of David Wayne COPPIE & Betty Ann Coppie, Debtors.
Appeal of Gordon E. GOUVEIA, Trustee.
In the Matter of Ray Marvin McCOWEN, Debtor.
Appeal of Gordon E. GOUVEIA, Trustee.

Nos. 83-1226, 83-1227.
|
Submitted Feb. 9, 1984.*
|
Decided March 1, 1984.
|
Rehearing and Rehearing En Banc Denied March 30, 1984.

Appeals were taken from orders of the United States Bankruptcy Court for the Northern District of Indiana, Russell H. Nehrig, J., holding that garnished wages did not constitute preferences avoidable by the trustee. The Court of Appeals held that garnishment of debtor's wages within 90 days of when debtor filed petition in bankruptcy, pursuant to garnishment order issued more than 90 days before filing of petition, did not constitute preferential transfer avoidable by trustee in bankruptcy since, under Indiana law, garnishee was accountable from date garnishment summons was served for any money owed to judgment debtor.

Affirmed.

West Headnotes (1)

**[1]** **Bankruptcy**
Judicial Liens; Garnishment, Attachment, or Execution

Garnishment of debtor's wages within 90 days of when debtor filed petition in bankruptcy, pursuant to garnishment order issued more than 90 days before filing of petition, did not constitute preferential transfer avoidable by trustee in bankruptcy since, under Indiana law, garnishee was accountable from date garnishment summons was served for any money owed to judgment debtor. Bankr.Code, 11 U.S.C.A. § 547; IC 34-1-11-21 (1982 Ed.).

46 Cases that cite this headnote

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Thomas L. Tuytschaevers, Borns, Quinn, Kopko & Lindquist, Merrillville, Ind., for debtors.

Before CUMMINGS, Chief Judge, POSNER and COFFEY, Circuit Judges.

**Opinion**

PER CURIAM.

These cases present the issue of whether the garnishment of a debtor's wages within ninety days of when the debtor filed a petition in bankruptcy, pursuant to a garnishment order issued more than ninety days before filing of the petition, constitutes a preferential transfer avoidable by the trustee. We agree with the bankruptcy judge that, under Indiana law, it is not and affirm the judgment below.

I.

The factual circumstances of the two cases before us do not differ significantly. In each case, an Indiana court issued a garnishment order against the debtor's wages more than ninety days prior to the debtor's filing of a chapter 7 petition in bankruptcy and the debtor's wages were garnished within the ninety-day period. Following the debtors' discharges, the trustee commenced the instant actions to recover the wages garnished as preferential transfers. *See* 11 U.S.C. § 547 (1982). The bankruptcy judge held that the garnished wages did not constitute preferences. The trustee appealed, both parties agreeing to appeal directly to this court. *See* 28 U.S.C. § 1293(b) (Supp. IV 1980); Bankruptcy Reform Act of

No. 95-598, § 405(c)(2), 92 Stat. 2685; *In re UNR Industries, Inc.,* 725 F.2d 1111 at 1114-1115 (7th Cir. 1984).

II.

Many courts have confronted the factual situation before us here, but there is no consensus as to whether the garnishment in this situation constitutes a preferential transfer.[1] The different results are often, though not always, attributable to varying state law because state law governs in determining when a transfer of the debtor's property has occurred. *See* cases cited *supra* note 1; 4 Collier on Bankruptcy ¶ 547.46 (15th ed.).

In Indiana, the garnishee is accountable, from the day the garnishment summons is served, to the plaintiff for any money he owes to the judgment debtor. Ind.Code § 34-1-11-21 (1976). Following a hearing, a court may order, as apparently happened here, that the judgment be a continuing lien on the future income of the debtor, i.e. continuous garnishment. Ind.Code § 34-1-44-7 (1976). At the time of the garnishments at issue here, this continuing lien could not exceed 10% of the debtors' income. *Id.* In this respect, the Indiana statutes were similar to the New York statutes involved in *In re Riddervold,* 647 F.2d 342 (2d Cir.1981), in that the statutes, in effect, worked a novation of 10% of the debtor's salary. Following court orders that the liens on these debtors' future income be continuous, the debtors no longer had a property interest in 10% of their future ***953** salaries. *See In re Woodman,* 8 Bankr. 686, 688 (Bkrtcy.W.D.Wis.1981). Rather, the employers owed that portion of their salaries directly to the garnishment plaintiffs and were liable to the plaintiffs for those amounts if the wages were not withheld pursuant to the court orders. True, the employers were not liable until the wages were actually earned, but once the court orders were entered the debtors were no longer legally entitled to 10% of their future salaries. Because the court orders legally transferred 10% of the debtors' wages to the garnishment plaintiffs, there were no transfers at the time of the actual garnishments in question. The Bankruptcy Judge ruled correctly that because no transfer of the debtors' property occurred within ninety days of the filing of the petition, there was no avoidable preference in either of the cases before us.

The debtors argue that § 547(e)(3)[2] requires a different result. We disagree. This section was enacted to overrule this court's decision in *Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.,* 408 F.2d 209 (7th Cir.1969). Sen.Rep. No. 95-989, 95th Cong., 2d Sess. 89 (1978), *reprinted in* 1978 U.S.Code Cong. & Ad.News 5787, 5875; H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 374 (1978), *reprinted in* 1978 U.S.Code Cong. & Ad.News 5963, 6330. In *Grain Merchants,* this court held that rights acquired in accounts receivable within the preference period were not a preference when the bank's security interest in after-acquired accounts receivable was perfected more than four months prior to filing of the bankruptcy petition. Although there are factual similarities between *Grain Merchants* and the cases before us, the analogy is not perfect. The most important distinction is that under Indiana law, the debtors retained no interest in 10% of their future wages following the entry of the garnishment orders. In contrast, the filing of financing statements in *Grain Merchants* did not transfer ownership of the debtor's future accounts receivable; that debtor would acquire some rights in the future accounts receivable when the accounts receivable came into existence. Section 547(e)(3) does not come into play in this case simply because after a garnishment order providing for a continuing lien is entered in Indiana, a debtor will never acquire rights in the portion of his or her wages to be garnished in the future. Once a garnishment order has been entered by a court, the debtor's rights in 10% of his or her future wages are irrevocably transferred to the garnishment plaintiff.

Accordingly, we affirm the order of the bankruptcy judge.

**All Citations**

728 F.2d 951, 10 Collier Bankr.Cas.2d 503, 11 Bankr.Ct.Dec. 913, Bankr. L. Rep. P 69,746

Footnotes

* After preliminary examination of the briefs, the court notified the parties that it had tentatively concluded that oral argument would not be helpful to the court in this case. The notice provided that any party might file a "Statement as to Need of Oral Argument." *See* Rule 34(a), Fed.R.App.P.; Circuit Rule 14(f). No such statement having been filed, the appeal has been submitted on the briefs and record.

1 *See, e.g., In re Riddervold,* 647 F.2d 342 (2d Cir.1981) (applying New York law); *In re Certain,* 30 B.R. 379 (Bkrtcy.D.Conn.1983); *In re Yamamoto,* 21 B.R. 58 (Bkrtcy.D.Haw.1982); *In re TMIC Industrial Cleaning Co.,* 19 B.R.

  

397 (Bkrtcy.W.D.Mo.1982); *In re Brinker,* 12 B.R. 936 (Bkrtcy.D.Minn.1981); *In re Woodman,* 8 B.R. 686 (Bkrtcy.W.D.Wis.1981) (no preference). *Contra In re Stoddard,* 23 B.R. 226 (Bkrtcy.S.D.N.Y.1982) (applying Virginia law); *In re Larson,* 21 B.R. 264 (Bkrtcy.D.Utah 1982); *In re Walden,* 19 B.R. 901 (Bkrtcy.E.D.Tenn.1982); *In re Mayo,* 19 B.R. 630 (E.D.Va.1981); *In re Eggleston,* 19 B.R. 280 (Bkrtcy.M.D.Tenn.1982); *In re Evans,* 16 B.R. 731 (Bkrtcy.N.D.Ga.1982); *In re Emery,* 13 B.R. 689 (Bkrtcy.D.Vt.1981); *In re Brengle,* 10 B.R. 360 (Bkrtcy.D.Del.1981); *In re Cox,* 10 B.R. 268 (Bkrtcy.D.Md.1981) (preference).

2 11 U.S.C. § 547(e)(3) (1982) states: "For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred."

**End of Document**

KeyCite Yellow Flag - Negative Treatment
Distinguished by In re Tops Appliance City, Inc., 3rd Cir.(N.J.), June 21, 2004

249 F.3d 445
United States Court of Appeals,
Sixth Circuit.

In re Sheri Whorley MOREHEAD, a/k/a Sheri Lynn Whorley, Debtor.
Sheri Whorley Morehead, Appellant,
v.
State Farm Mutual Automobile Insurance Company, Appellee.

No. 99-6430.
|
Argued: March 14, 2001.
|
Decided and Filed: May 3, 2001.

Chapter 7 debtor brought adversary proceeding to recover, as preferential transfers, wages paid to judgment creditor pursuant to order of wage garnishment served on debtor's employer outside 90-day preference period. The United States Bankruptcy Court for the Western District of Kentucky entered judgment in favor of creditor, on theory that "transfer" occurred outside preference period, when order of wage garnishment was served on debtor's employer. Debtor appealed. The District Court, Charles M. Allen, J., affirmed. On further appeal, the Court of Appeals, Patricia A. Gaughan, District Judge, sitting by designation, held that "transfer" did not occur, pursuant to garnishment order, until debtor actually earned wages less than 90 days prior to commencement of her Chapter 7 case.

Reversed.

West Headnotes (8)

[1] **Bankruptcy**
Conclusions of Law; De Novo Review

Bankruptcy court's conclusions upon questions of law arising under the Bankruptcy Code are reviewed de novo. Bankr.Code, 11 U.S.C.A. § 101 et seq.

2 Cases that cite this headnote

[2] **Bankruptcy**
Judicial Liens; Garnishment, Attachment, or Execution

Wage garnishment, as involuntary mode of parting with property, qualifies as "transfer," for preference purposes. Bankr.Code, 11 U.S.C.A. §§ 101(54), 547(b).

2 Cases that cite this headnote

[3] **Bankruptcy**
When Transfer Occurs

Generally, "transfer" is made, for preference purposes, at time that it is perfected. Bankr.Code, 11 U.S.C.A. § 547(e)(2)(B).

Cases that cite this headnote

[4] **Bankruptcy**
Preferences
**Bankruptcy**
When Transfer Occurs

Federal law determines what constitutes "transfer" and when it is complete, for preference purposes. Bankr.Code, 11 U.S.C.A. §§ 101(54), 547.

1 Cases that cite this headnote

[5] **Bankruptcy**
Preferences

While federal law determines what constitutes "transfer," for preference purposes, Bankruptcy Code definition of "transfer" includes concepts of property and interests of property, which are governed by state law. Bankr.Code, 11 U.S.C.A. §§ 101(54), 547(b).

2 Cases that cite this headnote

  

[6] **Garnishment**
Creation and Existence of Lien or Priority

Under Kentucky law, garnishment lien is perfected upon service of garnishment order on garnishee. KRS 425.506(1, 2), 427.005(1).

4 Cases that cite this headnote

[7] **Execution**
Wages and Credits Subject Thereto
**Garnishment**
Contingent Liabilities

Kentucky wage garnishment statute operates as recognition of garnishor's rights in property to be garnished, but does not grant it a property right in future earnings. KRS 425.506(1).

1 Cases that cite this headnote

[8] **Bankruptcy**
Judicial Liens; Garnishment, Attachment, or Execution
**Bankruptcy**
When Transfer Occurs

"Transfer" did not occur, pursuant to order of wage garnishment served on debtor's employer outside 90-day preference period, until debtor actually earned wages and thereby acquired rights therein less than 90 days prior to commencement of her Chapter 7 case; accordingly, wages could be recovered under preference provision. Bankr.Code, 11 U.S.C.A. §§ 101(54), 547(e)(3).

7 Cases that cite this headnote

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Richard L. Walls (argued and briefed), Bennett, Bowman, Triplett & Vittitow, Owensboro, KY, for Appellee.

Before: KENNEDY and SUHRHEINRICH, Circuit Judges; GAUGHAN, District Judge.[*]

**OPINION**

PATRICIA A. GAUGHAN, District Judge.

Debtor Sheri Whorley Morehead appeals the district court's order affirming a decision of the bankruptcy court which held certain fund transfers to Appellee State Farm Mutual Insurance Company (hereafter "State Farm") were not avoidable preferential transfers. For the reasons set forth below, we **REVERSE** the judgment of the district court.

**I.**

The parties stipulated to the following facts before the bankruptcy court. State Farm filed a lawsuit against Morehead on January 3, 1993 and obtained a judgment against her on March 24, 1995. State ***447** Farm issued a wage garnishment to Morehead's employer on or about February 12, 1996, September 9, 1996 and June 12, 1997. On November 12, 1997, Morehead filed a voluntary petition in Bankruptcy Court under Chapter 7. On November 14, 1997, the bankruptcy court entered an order staying wage deductions by creditors. Within the 90 days immediately preceding the filing of Morehead's bankruptcy, State Farm withheld Seven Hundred Twenty-one Dollars and Thirty-five Cents ($721.35) from her paycheck.

The trustee did not attempt to avoid the transfer. However, Morehead filed an Adversary Proceeding on January 28, 1998 to recover these funds.

The bankruptcy court found that State Farm obtained its status as a perfected lien creditor when it served the garnishment order on Morehead's employer. Because perfection occurred prior to the beginning of the 90-day preference period, the bankruptcy court held that no preferential transfer occurred. The district court agreed and affirmed. Morehead thereafter filed a timely notice of appeal.

**II.**

[1] Questions of law arising under the Bankruptcy Code are reviewed de novo. *United States v. Hunter (In re*

*Walter),* 45 F.3d 1023, 1027 (6th Cir.1995).

On appeal, Morehead argues that she did not acquire rights in the garnished wages at issue until they were actually earned. Because the Bankruptcy Code requires that the debtor acquire rights in property before it can be transferred, Morehead argues that the transfer could not occur until the wages were earned. Thus, Morehead claims that she was entitled to avoid the transfer to State Farm of wages earned during the 90-day preference period.

State Farm argues that, because it perfected the garnishment of Morehead's wages outside the 90-day preference period and because Kentucky law recognizes property rights in future earnings, the garnishment of Morehead's wages did not constitute a preferential transfer.

[2] 11 U.S.C. § 547(b) allows a transfer of the debtor's interest in property to be avoided under certain circumstances. At issue in this appeal, 11 U.S.C. § 547(b)(4)(A) authorizes the avoidance of a transfer made "on or within 90 days before the date of the filing of the petition." The Bankruptcy Code defines a transfer as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property...." 11 U.S.C. § 101(54). Because a wage garnishment is an involuntary mode of parting with property, it constitutes a transfer under the Code.

[3] Generally, a transfer is made at the time it is perfected. 11 U.S.C. § 547(e)(2)(B). According to the Bankruptcy Code, a transfer is perfected "when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." 11 U.S.C. § 547(e)(1)(B). "A more precise definition of 'perfection' is left to state law." *Battery One-Stop Ltd. v. Atari Corp. (In re Battery One-Stop Ltd.)* 36 F.3d 493, 495 (6th Cir.1994). However, 11 U.S.C. § 547(e)(3) places a caveat on the general rule by providing, "For the purpose of this section, a transfer is not made until the debtor has acquired rights in the property transferred."

[4] [5] Federal law determines what constitutes a transfer and when it is complete. *Barnhill v. Johnson,* 503 U.S. 393, 397, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992). However, the definition of a transfer includes ***448** concepts of property and interests of property which are governed by state law. *Id.* at 398, 112 S.Ct. 1386.

[6] Kentucky law defines earnings as "compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus or otherwise, and includes periodic payments pursuant to a pension or retirement program." Ky.Rev.Stat. § 427.005(1). Kentucky Revised Statute § 425.506(1) provides for a continuing wage garnishment which creates "a lien on all nonexempt earnings earned during the pay period in which the order is served on the employer and during those succeeding pay periods which may be designated by the order." In addition, § 425.506(2) grants priority to orders of wage garnishment "according to the date of service on the employer." Thus, under Kentucky law, the service of a garnishment order upon the garnishee perfects the garnishment lien.

[7] The Kentucky wage garnishment statute operates as a recognition of the garnishor's rights in the property to be garnished. However, it does not grant the debtor a property right in future earnings. In fact, Kentucky Revised Statute § 425.506(1) specifically requires that the attached wages be earned during the designated pay periods, thereby recognizing that the debtor must have rights to the wages before the garnishment lien can attach.

[8] Regardless of when a property lien is perfected, 11 U.S.C. § 547(e)(3) requires that the debtor have rights in the property before it can be transferred. In the wage garnishment context, this cannot logically occur until the debtor performs the services that entitle her to receive the wages that are subject to garnishment. This is consistent with Kentucky law. We therefore hold that when wages are earned during the preference period, transfer of those wages pursuant to a garnishment order is avoidable under 11 U.S.C. § 547(b)(4)(A).

This Court's decision in *Battery One-Stop,* a case cited by State Farm, does not compel a contrary conclusion because that case is distinguishable on several grounds. The court in *Battery One-Stop* did not discuss or rely on 11 U.S.C. § 547(e)(3), nor was it required to since no question was raised as to whether the debtor had rights to the funds that were garnished. 36 F.3d at 494. In addition, that case did not involve a continuing wage garnishment, but the garnishment of a bank account. *Id.*

Likewise, *Conner,* another case cited by State Farm, is distinguishable. In *Conner,* the Eleventh Circuit failed to consider the applicability of 11 U.S.C. § 547(e)(3), instead relying on § 547(e)(1)(B) and holding that the transfer occurred at the time the wage garnishment was served on the employer. *In re Conner,* 733 F.2d 1560, 1562. However, *Conner* is inapposite because in that case the garnishee employer turned over the garnished funds to the state court prior to the beginning of the 90-day preference period. *Id.* at 1561. Thus, it is clear that the wages at issue were not earned by the debtor during the preference period.

The decisions from other circuits relied on by State Farm are neither controlling nor persuasive. *See Riddervold v. Saratoga Hosp. (In re Riddervold),* 647 F.2d 342 (2d Cir.1981); *In re Coppie,* 728 F.2d 951 (7th Cir.1984). Both predate *Barnhill,* which requires that federal law determine when transfers are made.

In *Riddervold,* the Second Circuit held that at the time the wage garnishment is executed, it creates a continuing levy which acts as a novation of the debtor's rights and interests in the garnished portion ***449** of his wages. 647 F.2d at 346. The court reasoned that, instead of owing the employee's entire salary to the employee, the employer owes a portion of it to the garnishor. *Id.* Thus, the court concluded that no transfer occurred during the preference period. *Id.* The court in *Riddervold* did not consider the applicability of 11 U.S.C. § 547(e)(3) to a continuing wage garnishment.

The Seventh Circuit held similarly in *Coppie* that the execution of a wage garnishment acts as a novation of the debtor's rights and interests in that portion of his wages which are garnished. 728 F.2d at 952. The court also concluded that 11 U.S.C. § 547(e)(3) was inapplicable because the debtor "will never acquire rights in the portion of his or her wages to be garnished in the future." *Id.* at 953.

We reject the approach set forth by the courts in *Riddervold* and *Coppie* since they seemingly ignore the plain language of 11 U.S.C. § 547(e)(3). It is difficult to view a garnishment order as a novation, which is a "substitution by mutual agreement of one debtor for another or of one creditor for another, whereby the old debt is extinguished." *Black's Law Dictionary* 1064 (6th Ed.1990). The novation theory reasons that once the garnishment order has been perfected, the debtor never obtains any right to the garnished funds. This directly contradicts 11 U.S.C. § 547(e)(3), which states that a transfer cannot occur until the debtor has acquired rights in the property transferred.

It is illogical to find that a debtor may acquire rights in future wages when they have not yet been earned. The mere fact that a creditor perfects a garnishment order on a debtor's future wages does not guarantee that the debtor will ever earn any wages. The debtor retains the choice to work for the garnishee employer, to work for someone else or not to work at all. To the extent the debtor chooses to work for the garnishee employer, any earnings during the 90-day preference period established by 11 U.S.C. § 547(b)(4)(A) that are transferred to the creditor pursuant to a garnishment order are avoidable as a preferential transfer, regardless of the date of perfection of the garnishment order.

The bankruptcy courts which have considered 11 U.S.C. § 547(e)(3) have almost uniformly held that a wage garnishment is an avoidable transfer where the garnishment is of wages earned during the preference period. *See, e.g., Wade v. Midwest Acceptance Corp. (In re Wade),* 219 B.R. 815 (8th Cir.BAP 1998); *In re Johnson,* 239 B.R. 416 (Bankr.M.D.Ala.1999); *Arway v. Mt. St. Mary's Hosp. (In re Arway),* 227 B.R. 216 (Bankr.W.D.N.Y.1998); *In re Fagan,* 26 B.R. 212 (Bankr.W.D.Ky.1982); *Cox v. General Electric Credit Corp. (In re Cox),* 10 B.R. 268 (Bankr.D.Md.1981). *But see Wilkey v. Community Methodist Hosp. (In re Edwards),* 219 B.R. 970 (Bankr.W.D.Ky.1998) (citing *Battery One-Stop* for the proposition that "to avoid a post-judgment garnishment as a preference, the garnishment order must be served upon the garnishee within the preference period"). *See also* 1 David G. Epstein et al., Bankruptcy § 6-15 (1992); 5 Collier on Bankruptcy § 547.05 [7][b] (Lawrence P. King ed., 1996).

## III.

For the foregoing reasons, we **REVERSE** the judgment of the district court.

### All Citations

249 F.3d 445, 46 Collier Bankr.Cas.2d 56, Bankr. L. Rep. P 78,397, 2001 Fed.App. 0143P

Footnotes

* The Honorable Patricia A. Gaughan, United States District Judge for the Northern District of Ohio, sitting by designation.

850 F.3d 816
United States Court of Appeals,
Fifth Circuit.

In the MATTER OF: Christon JACKSON, Debtor
Tower Credit, Incorporated, Appellant
v.
Martin A. Schott, Appellee

No. 16-30274
|
FILED March 13, 2017

**Synopsis**
**Background:** Chapter 7 trustee brought adversary proceeding to recover wages that had been garnished prepetition, as representing preferential transfers of interest of debtor in property. The United States Bankruptcy Court for the Middle District of Louisiana, Douglas D. Dodd, J., granted trustee's motion for summary judgment, and creditor appealed. The District Court, John W. deGravelles, J., 550 B.R. 299, affirmed. Creditor appealed.

**[Holding:]** The Court of Appeals, James L. Dennis, Circuit Judge, held that transfer of Chapter 7 debtor's wages did not occur when garnishment order was served, more than 90 days prepetition, before debtor had even acquired interest in wages, but only as such an interest was acquired.

Affirmed.

West Headnotes (4)

[1] **Bankruptcy**
Conclusions of law; de novo review
**Bankruptcy**
Clear error

On appeal from district court's affirmance of judgment of bankruptcy court, the Court of Appeals applies same standard of review that district court applied, reviewing bankruptcy court's factual findings for clear error, and its legal conclusions and determinations on mixed questions of fact and law de novo. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[2] **Bankruptcy**
Nature of Transfer
**Bankruptcy**
When Transfer Occurs

What constitutes a transfer and when that transfer is complete, whether inside or outside 90-day preference period, is question of federal law. 11 U.S.C.A. § 547(b)(4)(A).

1 Cases that cite this headnote

[3] **Federal Courts**
Property

State law generally determines the nature of property interests involved in purported transfers, but only in absence of controlling federal law.

Cases that cite this headnote

[4] **Bankruptcy**
Judicial liens; garnishment, attachment, or execution

Transfer of Chapter 7 debtor's wages did not occur when garnishment order was served, more than 90 days prepetition, before debtor had even acquired interest in wages, but only as such an interest was acquired; accordingly, trustee was entitled to avoid, as preferences, wages that were paid over during preference period, despite creditor's contention that any transfer occurred outside preference-period when garnishment order was served. 11 U.S.C.A. § 547(b)(4)(A), (e)(3).

1 Cases that cite this headnote

  

Appeal from the United States District Court for the Middle District of Louisiana, John W. deGravelles, U.S. District Judge

**Attorneys and Law Firms**

Richard D. Bankston, Baton Rouge, LA, for Appellant.

Martin A. Schott, Pro Se.

Before DAVIS, DENNIS, and SOUTHWICK, Circuit Judges.

**Opinion**

JAMES L. DENNIS, Circuit Judge:

In 2009, Tower Credit, Incorporated, obtained a money judgment in a Louisiana state court against Christon Jackson. Seeking to collect, Tower obtained a garnishment order, served it on Jackson's employer on January 19, 2012, and began collecting Jackson's garnished wages. On November 17, 2012, Jackson filed for Chapter 7 bankruptcy protection in the United States Bankruptcy Court for the Middle District of Louisiana. The bankruptcy court appointed Martin Schott as trustee to administer Jackson's estate. In ***818** 2014, the trustee initiated this adversary action, seeking to void the garnishments collected by Tower within ninety days prior to Jackson's filing for bankruptcy as preferential transfers pursuant to 11 U.S.C. § 547(b). The trustee initially sought the return of $2,034.81, but the parties have since stipulated that the actual amount at issue is $1,756.04. The bankruptcy court ultimately granted summary judgment in favor of the trustee, and the district court affirmed on appeal. Tower timely appealed to this court, arguing that the garnished wages should be considered transferred on the date the garnishment order was served, before the preference period, and therefore that the trustee is not entitled to recover them. We disagree and therefore affirm.

## DISCUSSION

[1]On appeal in a bankruptcy case, we apply the same standard of review that the district court applied: "[T]he bankruptcy court's factual findings are reviewed for clear error; its legal conclusions and mixed questions of fact and law, de novo." *In re Mercer*, 246 F.3d 391, 402 (5th Cir. 2001) (italics removed). Section 547(b) provides, in relevant part:

> [T]he trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> > (A) on or within 90 days before the date of the filing of the petition; ...
> >
> > (B) ...
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> > (A) the case were a case under chapter 7 of this title;
> >
> > (B) the transfer had not been made; and
> >
> > (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Tower contests only the fourth element, arguing that Jackson's interest in the garnished wages was transferred to Tower when it served the garnishment order on Jackson's employer, more than ninety days before the filing of Jackson's petition.

[2] [3]"What constitutes a transfer and when it is complete is a matter of federal law." *Barnhill v. Johnson*, 503 U.S. 393, 397, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992) (citation and internal quotation marks omitted). State law generally determines the nature of property interests involved in purported transfers, but only "[i]n the absence of controlling federal law." *See id.* at 398, 112 S.Ct. 1386; *see also Local Loan Co. v. Hunt*, 292 U.S. 234, 243–45, 54 S.Ct. 695, 78 L.Ed. 1230 (1934) (declining to adhere to an Illinois state-law fiction that "an assignment of future wages creates a lien effective from the date of the assignment, which is not invalidated by the assignor's discharge in bankruptcy" and stating, "Local rules subversive [to the general purpose and policy of the bankruptcy act] cannot be accepted as controlling the action of a federal court.").

[4]Section 547(e) provides the governing principles that determine the timing of a transfer. As relevant to the instant case, a transfer is generally made at the time it is "perfected," § 547(e)(2)(B), which, in the context of non-real property, occurs when "a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee." § 547(e)(1)(B). However, § 547(e)(3) qualifies ***819** that general principle and

provides that "a transfer is not made until the debtor has acquired rights in the property transferred." *See also In re Latham*, 823 F.2d 108, 110 (5th Cir. 1987) (stating, "[A] lien that is perfected outside the preference period does not attach to property rights transferred to the Debtor during the preference period" and citing *Tabita v. IRS*, 38 B.R. 511, 513 (E.D. Pa. 1984) for the proposition that "wages earned within preference period are subject to preference even though writ of attachment was served beyond the preference period").[1]

Tower contends that as soon as it served the garnishment order on Jackson's employer, no creditor on a simple contract could have acquired a judicial lien superior to Tower's interest. Thus, it argues that the transfer of the interest in Jackson's garnished wages was perfected at that time pursuant to § 547(e)(1)(B). That would be true, except for the additional instruction of § 547(e)(3), which requires the debtor to have rights in the property before any transfer can occur.

In *Local Loan*, the Supreme Court held, albeit in the context of a bankruptcy discharge dispute, "The earning power of an individual is the power to create property; but it is not translated into property within the meaning of the Bankruptcy Act until it has brought earnings into existence."[2] 292 U.S. at 243, 54 S.Ct. 695. Thus, as the Sixth Circuit explained in *In re Morehead*, 249 F.3d 445, 448 (6th Cir. 2001), in the wage garnishment context, a debtor cannot logically obtain rights in her future wages until she performs the services that entitle her to receive those wages. 249 F.3d at 448. The *Morehead* court therefore held that "when wages are earned during the preference period, transfer of those wages pursuant to a garnishment order is avoidable under ... § 547(b)[ ]." *Id.* In other words, because Jackson had not earned the disputed wages before the ninety-day preference period, he had acquired no rights to those wages and, under § 547(e)(3), could not have transferred such rights to Tower prior to the preference period. *See Morehead*, 249 F.3d at 448; *see also Local Loan*, 292 U.S. at 243, 54 S.Ct. 695; *Latham*, 823 F.2d at 110.

Tower asserts that *Morehead* is "limited to states wherein the transfer does not occur when the garnishment is served." But it is federal law, not state law, that determines when the transfer occurred, *Barnhill*, 503 U.S. at 397, 112 S.Ct. 1386, and § 547(e)(3) requires that a debtor acquire rights in the property in question before any transfer is made. That is not to say that state law is never relevant to the application of § 547(e)(3); indeed, in the absence of controlling federal law, state law will determine whether the debtor had acquired rights in the property. *See* ***820** *Barnhill*, 503 U.S. at 397, 112 S.Ct. 1386. There is controlling federal law in the context of a debtor's rights in future wages, however, and it provides that "[t]he earning power of an individual ... is not translated into property ... until it has brought earnings into existence." *See Local loan*, 292 U.S. at 243, 54 S.Ct. 695. Moreover, Tower has not even contended that Louisiana law provides employees with present rights in their unearned, future wages.

Tower cites three cases from the 1980s in which other circuits held that a transfer of garnished wages occurred at the time the garnishment was served on the employer. *See In re Conner*, 733 F.2d 1560 (11th Cir. 1984); *In re Coppie*, 728 F.2d 951 (7th Cir. 1984); *In re Riddervold*, 647 F.2d 342 (2d Cir. 1981). In *Conner*, the Eleventh Circuit relied on § 547(e)(1)(B) and held that, because no contract creditor could obtain a superior judicial lien after a garnishment was executed, the transfer occurred at the time of the execution. 733 F.2d at 1562. In *Riddervold*, the Second Circuit held that at the time the garnishment was executed it created a "continuing levy," which under New York law acted as a novation of all of the debtor's rights in his wages, and thus that there was no transfer during the preference period. 647 F.2d at 346. Importantly, neither *Riddervold* nor *Conner* even considered the effect of § 547(e)(3), and both predated *Barnhill*, in which the Supreme Court held that federal law governs the determination of whether and when a transfer occurred. *See Morehead*, 249 F.3d at 448–49 (discussing and rejecting *Riddervold* and *Conner*).

In *Coppie*, the Seventh Circuit held, similar to *Riddervold*, that the execution of a garnishment acted as a novation of all of the debtor's interests in the wages under Indiana law so that there could not have been a transfer within the preference period. 728 F.2d at 953. Addressing § 547(e)(3), the court found it inapplicable because the debtor "will never acquire rights in the portion of his or her wages to be garnished in the future" as those were "irrevocably transferred to the garnishment plaintiff." *Id.*

In our view, the *Coppie* court's conclusion that the debtor's rights in his future wages were "irrevocably transferred" at the time the garnishment order was entered conflicts with § 547(e)(3)'s instruction that no transfer of an interest in property is made before the debtor acquires rights in the property. Like *Conner* and *Riddervold*, *Coppie* predated *Barnhill*, and it appears that the Seventh Circuit itself no longer considers *Coppie*'s holding good law: that court subsequently concluded that pre-*Barnhill* cases holding that a transfer occurs when a notice of garnishment is served, including *Conner*, did not survive the Supreme Court's decision in *Barnhill*. *See In re Freedom Grp., Inc.*, 50 F.3d 408, 412 (7th Cir. 1995).

The trio of cases cited by Tower has been roundly criticized on the grounds discussed. *See, e.g.*, *Morehead*, 249 F.3d at 448–49; *Freedom Group*, 50 F.3d at 412; *In re White*, 258 B.R. 129, 134 (Bankr. D.N.J. 2001); *In re Mays*, 256 B.R. 555, at 560 n.7; *Tabita*, 38 B.R. at 513; *In re Dunn*, 56 B.R. 275, 278 (Bankr. M.D. La. 1985); *In re Perry*, 48 B.R. 591, 598 (Bankr. M.D. Tenn. 1985); *see also* 5 Collier on Bankruptcy ¶ 547.05 (16th ed.) ("The analysis of these three appellate courts is wrong.... The timing scheme in section 547(e) does not exclude garnishment liens. Until the debtor earns the wages, there is no property that the creditor can garnish or that the debtor can transfer. The creditor's right to the particular funds that are garnished exists only because the debtor is entitled to be paid those funds as wages; it does not exist unless the debtor first acquires the right to be paid."). We join the ***821** other courts that have rejected the cases cited by Tower and decline to follow those cases.

The combination of Supreme Court precedent and the overwhelming weight of persuasive authority applying § 547(e)(3) make clear that a debtor's wages cannot be transferred until they are earned. Thus, we hold that a creditor's collection of garnished wages earned during the preference period is an avoidable transfer made during the preference period even if the garnishment was served prior to that period. We therefore AFFIRM the district court's judgment.

## All Citations

850 F.3d 816, 63 Bankr.Ct.Dec. 231, Bankr. L. Rep. P 83,076

## Footnotes

1 *Latham*'s favorable citation of *Tabita* for this proposition is arguably dicta, as *Latham* did not involve wage garnishment. *See* 823 F.2d at 109.

2 The Bankruptcy Act was repealed in 1978 and replaced by the current Bankruptcy Code. *See* Bankruptcy Reform Act of 1978, 112 Stat. 2549, 2682. However, the Court in *Local Loan* grounded its holding in the purpose of the Bankruptcy Act to "relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." *See* 292 U.S. 234 at 244, 54 S.Ct. 695 (internal quotation marks omitted). This remains a primary purpose of the Bankruptcy Code as well, and the courts have continued to cite and apply *Local Loan* for this proposition. *See, e.g.*, *Grogan v. Garner*, 498 U.S. 279, 286, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991); *In re Shcolnik*, 670 F.3d 624, 632 (5th Cir. 2012). We therefore conclude that *Local Loan*'s holding that unearned, future wages are not property within the meaning of the bankruptcy laws remains valid and binding upon us.

2017 WL 1379338
Only the Westlaw citation is currently available.
United States Bankruptcy Court,
E.D. Michigan, Southern Division.

IN RE: Sheldon M. KORN, Debtor.
Lawrence C. Lenchner, et. al., Plaintiffs,
v.
Sheldon M. Korn, Defendant.

Case No. 14–41173
|
Adv. Pro. No. 14–4408
|
Signed April 14, 2017

**Synopsis**
**Background:** Judgment creditor, the brother-in-law and former business associate of Chapter 7 debtor, together with certain limited liability companies (LLCs) that judgment creditor had formed, filed adversary complaint against debtor, seeking determination that his debt of over $1.9 million to them arising out of Michigan state-court judgment was nondischargeable. Plaintiffs moved for partial summary judgment based on the doctrine of collateral estoppel.

**Holdings:** The Bankruptcy Court, Thomas J. Tucker, J., held that:

[1] in a nondischargeability proceeding in which the "actual fraud" alleged is an inducement-based form of fraud, it is necessary for the creditor to prove "justifiable reliance" on the false impression;

[2] under Michigan law, the "actually litigated" requirement of collateral estoppel was not satisfied regarding the justifiable reliance element of the fraud discharge exception;

[3] debtor was not collaterally estopped from contesting the nondischargeability of the debt under the discharge exception for fiduciary fraud or defalcation; and

[4] debtor was not collaterally estopped from contesting that any of the judgment debt was nondischargeable under the discharge exception for debts obtained by willful and malicious injury.

Motion denied.

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**[Edited for Length by SCW]**

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**Attorneys and Law Firms**

Charles D. Bullock, Elliot G. Crowder, Stevenson & Bullock, P.L.C., Southfield, Michigan, Attorneys for Plaintiffs.

Debra Beth Pevos, Howard S. Sher, Jacob & Weingarten, P.C., Southfield, Michigan, Attorneys for Defendant.

**OPINION REGARDING PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT**

Thomas J. Tucker, United States Bankruptcy Judge

***1** This adversary proceeding is before the Court on Plaintiffs' motion for summary judgment (Docket # 27, the "Motion"),[1] seeking summary judgment on Counts IV through VIII of Plaintiffs' complaint.[2] These counts seek a determination that a debt of over $1.9 million to Plaintiffs, arising out of a state court judgment, is nondischargeable in Defendant's bankruptcy case under 11 U.S.C. §§ 523(a)(2)(A) (Counts IV (false pretenses), V (false representation), and VI (actual fraud)); 523(a)(4) (Count VII); and 523(a)(6) (Count VIII). Plaintiffs argue that they are entitled to judgment on these counts based on the doctrine of collateral estoppel.

The Court concludes that Plaintiffs are not entitled to summary judgment in any respect, on any count of their complaint. Plaintiffs' Motion will be denied in its entirety.

**I. Facts**

Plaintiff Lawrence Lenchner ("Lenchner") is the brother-in-law of Defendant Sheldon Korn ("Sheldon"). Prepetition, Lenchner was involved in the development and sale of real estate with some limited liability companies Lenchner had formed (the "Lenchner Entities"). Lenchner and the Lenchner Entities had a business relationship with Sheldon; Sheldon's wife, Gale Korn; and Sheldon's two daughters, Shauna Korn and Ashley Korn (collectively, the "Korns"); and the Korn Family Limited Partnership ("KFLP").[3] The business relationship ended on a sour note in December 2002, when Lenchner ceased his association with the Korns.

**A. The state court litigation**

**1. The complaint and counterclaim**

The Korns and KFLP responded to the collapse of the business relationship by filing a complaint against Lenchner and the Lenchner Entities in the Circuit Court for the County of Charlevoix, Michigan, on January 15, 2003 (Case No. 03–1723–19–CB, the "State Court Lawsuit").[4] The state court proceedings were extensive and lengthy, and the collateral estoppel issues discussed in this opinion require the Court to describe the state court proceedings in detail.

The complaint by the Kerns and KFLP in the State Court Lawsuit included the following counts:

- Count I—"Money Owing For Advances"
- Count III [sic]—"Conversion"
- Count IV—"Liability Under [Mich. Comp. Laws §] 600.2919a"
- ***2** • Count V—"Misrepresentation (Fraudulent Or Innocent)"
- Count VI—"Silent Fraud"
- Count VII—"Bad Faith Promises"
- Count VIII—"Breach Of Fiduciary Duty"
- Count IX—"Tortious Interference"
- Count X—"Discharge/Termination In Violation of Public Policy, Or Alternatively, Violation of The Whistle–Blowers' Protection Act"
- Count XI—"Civil Conspiracy"
- Count XII—"Breach of Contract"
- Count XIII—"Promissory Estoppel"
- Count XIV—(not titled but alleging in relevant part, that "[a]s an alternative and/or in addition to Plaintiffs' right to recover under the foregoing Counts, Plaintiffs Sheldon and Gale Korn may be equitably entitled to own 50% of Business or of each Defendant, except for Defendant Lenchner."[5]

Lenchner and the Lenchner Entities responded to the state court complaint against them, in part, by filing counterclaims against the Korns and KFLP, alleging:

- Count I—"Conversion"
- Count II—"Civil Conspiracy to Commit Conversion"
- Count III—"Breach of Fiduciary Duty"

  

• Count IV—“Civil Conspiracy to Commit Breach of Fiduciary Duty”

• Count V—“Fraud”

• Count VI—“Silent Fraud”

• Count VII—“Innocent Misrepresentation”

• Count VIII—“Conspiracy to Commit Fraud, Silent Fraud and Innocent Misrepresentation”

• Count IX—“Promissory Estoppel”

• Count X—“Unjust Enrichment”
• Count XI—“Constructive Trust.”[6]

The basic facts alleged by Lenchner and the Lenchner Entities in support of their counterclaims were that the Korns, individually and through KFLP, engaged in a common scheme to defraud Lenchner and the Lenchner Entities, under which the Korns and KFLP (1) misrepresented to Lenchner and the Lenchner Entities that they were spending money Sheldon withdrew from the bank accounts of the Lenchner Entities for business purposes only, when in fact they were draining such accounts for personal use; and (2) failed to disclose to Lenchner and the Lenchner Entities that they intended to loot, and were looting, the Lenchner Entities.[7] Lenchner and the Lenchner Entities alleged further that they “reasonably relied upon the misrepresentations and fraudulent omissions made to them by Sheldon Korn” due to the family relationship between Lenchner and the Korns, and that Lenchner and the Lenchner Entities suffered damages as a result of the fraudulent scheme.[8] Lenchner and the Lenchner Entities alleged that under their fraudulent scheme, the Korns and KFLP “drain[ed] over $700,000 from [the bank] accounts [of some of the Lenchner Entities] for personal use.”[9]

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**[Edited for Length by SCW]**

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**III. Discussion**

. . . .

**[Edited for Length by SCW]**

. . . .

**E. Lenchner and the Lenchner Entities' § 523(a)(2)(A) claim**

**1. Elements under § 523(a)(2)(A)**

[14]Section 523(a)(2)(A) of the Bankruptcy Code provides:

> (a) A discharge under section 727 ... of this title does not discharge an individual debtor from any debt–
>
> ...
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
>> (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition[.]

11 U.S.C. § 523(a)(2)(A). "This section is phrased in the disjunctive, meaning that false pretenses, false representation and actual fraud are three separate grounds for nondischargeability [under § 523(a)(2)(A)]." *Becton, Dickinson & Co. v. Sterling* (*In re Sterling* ), 479 B.R. 444, 449 (Bankr. E.D. Mich. 2012)(citations omitted); *see also Tweedie v. Hermoyian* (*In re Hermoyian* ), 466 B.R. 348, 363 (Bankr. E.D. Mich. 2012). Lenchner and the Lenchner Entities seek summary judgment on their § 523(a)(2)(A) claims based on all three grounds.

. . . .

**[Edited for Length by SCW]**

**c. Actual fraud**

[21] [22] [23] [24] [25]"Actual fraud is broader than misrepresentation." *Mellon Bank, N.A. v. Vitanovich* (*In re Vitanovich* ), 259 B.R. 873, 877 (6th Cir. BAP 2001).

> [A]ctual fraud encompasses "any deceit, artifice, trick, or design involving direct and active operation of the mind, used to circumvent and cheat another."... "Fraud is a generic term, which embraces all the multifarious means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false suggestions or by the suppression of truth. No definite and invariable rule can be laid down as a general proposition defining fraud, and it includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated."
>
> "Actual fraud has been defined as intentional fraud, consisting in deception intentionally practiced to induce another to part with property or to surrender some legal right, and which accomplishes the end designed. It requires intent to deceive or defraud." ...
>
> [A]ctual fraud as used 11 U.S.C. § 523(a)(2)(A) is not limited to misrepresentations and misleading omissions. When a debtor intentionally engages in a scheme to deprive or cheat another of property or a legal right, that debtor has engaged in actual fraud and is not entitled to the fresh start provided by the Bankruptcy Code.

*Vitanovich*, 259 B.R. at 877.

***14** Recently, in *Husky Int'l Elects., Inc. v. Ritz*, ––– U.S. ––––, 136 S.Ct. 1581, 1586, 194 L.Ed.2d 655 (2016), the United States Supreme Court stated and described the elements of "actual fraud" under § 523(a)(2)(A):

> "Actual fraud" has two parts: actual and fraud. The word "actual" has a simple meaning in the context of common-law fraud: It denotes any fraud that "involv[es] moral turpitude or intentional wrong." "Actual" fraud stands in contrast to "implied" fraud or fraud "in law," which describe acts of deception that "may exist without the imputation of bad faith or immorality." Thus, anything that counts as "fraud" and is done with wrongful intent is "actual fraud."

(citation omitted).

In *Husky*, the individual Chapter 7 bankruptcy debtor, Ritz, had used his position as a director and shareholder in a corporation, Chrysalis, to cause that corporation to make a series of fraudulent transfers to other entities that Ritz controlled. Husky, a trade creditor of Chrysalis, claimed that these transfers amounted to "actual fraud" by Ritz, and created a nondischargeable debt owing by Ritz to Husky. In describing the agreed facts of the case, the Supreme Court stated that "Ritz drained Chrysalis of assets it could have used to pay its debts to creditors like Husky by transferring large sums of Chrysalis' funds to other entities Ritz controlled." 136 S.Ct. at 1585. The issue before the Supreme Court was whether this "intercompany transfer scheme" could constitute "actual fraud" under § 523(a)(2)(A), even though it did not involve any false representation by the bankruptcy debtor Ritz. Husky argued in the United States Court of Appeals for the Fifth Circuit and in the Supreme Court that "Ritz' asset-transfer scheme was effectuated through a series of fraudulent conveyances—or transfers intended to obstruct the collection of debt," and that this was "a recognizable form of 'actual fraud.' " *Id.* at 1586. The Fifth Circuit rejected that argument, holding that "actual fraud" required a misrepresentation. The Supreme Court reversed.

The Supreme Court held that the "actual fraud" ground for nondischargeability under § 523(a)(2)(A), unlike the false representation ground, "encompasses forms of fraud ... that can be effected without a false representation;" without a creditor's reliance on any statements, actions, or omissions by the debtor; and without the fraud occurring at the inception of the transaction(s) between the debtor and the creditor. *Id.* at 1586–90. The Court distinguished fraud consisting of fraudulent conveyances from what it called "inducement-based fraud"—*i.e.*, fraud that induced some detrimental reliance by a creditor, such as fraud based on a debtor's misrepresentation. The Court stated:

> Equally important, the common law also indicates that fraudulent conveyances, although a "fraud," do not require a misrepresentation from a debtor to a creditor. As a basic point, **fraudulent conveyances are not an inducement-based fraud**. Fraudulent conveyances typically involve "a transfer to a close relative, a secret transfer, a transfer of title without transfer of possession, or grossly inadequate consideration." In such cases, **the fraudulent conduct is not in dishonestly inducing a creditor to extend a debt**. It is in the acts of concealment and hindrance. In the fraudulent-conveyance context, therefore, the opportunities for a false representation from the debtor to the creditor are limited. The debtor may have the opportunity to put forward a false representation if the creditor inquires into the whereabouts of the debtor's assets, but that could hardly be considered a defining feature of this kind of fraud.

***15** *Id.* at 1587 (emphasis added) (citations omitted).

[26] [27]Under *Husky* and the pre-*Husky* case law, it is clear that "actual fraud" is broad enough to cover any form of fraud that is done with wrongful intent or that involves moral turpitude, including inducement-based fraud such as fraud based on a misrepresentation. One of the questions that arises after *Husky*, and that matters in this case, is whether the element of "justifiable reliance"—that is, actual reliance by the creditor that is "justifiable"—is necessary to establish "actual fraud" under § 523(a)(2)(A), when the fraud alleged is an inducement-based form of fraud. It is clear from *Husky* that "actual fraud" based on one or more fraudulent transfers does *not* require a showing of reliance, actual or justifiable. But in the present case, the alleged "actual fraud" by the Debtor is that the Debtor by words and/or conduct intentionally created a false impression intended to deceive the creditors, and that the creditors relied on such false impressions to their damage. In such a case, is it necessary for the creditor to prove "justifiable reliance" on the false impression? The Court concludes that the answer to this question is yes, based on the following review of cases decided both before and after *Husky*, and based on *Husky* itself.

Numerous cases decided before *Husky* held that justifiable reliance is a required element of "actual fraud" under § 523(a)(2)(A). Cases in this district, for example, held that "[t]o establish actual fraud, Plaintiff must show (1) a course of conduct intended to deceive; (2) justifiable reliance; and (3) proximate causation." *Sterling*, 479 B.R. 444, 449 (Bankr. E.D. Mich. 2012)(emphasis added); *see also General Motors, LLC v. Gunner (In re Gunner* ), No. 10-7685, 2013 WL 6628629, at *4 (Bankr. E.D. Mich. Dec. 10, 2013) (emphasis added) ("Actual fraud, which is broader than misrepresentation, requires a showing of (1) a course of conduct intended to deceive; (2) justifiable reliance; and (3) proximate causation.") (citing *Vitanovich*, 259 B.R. at 877 and *Rakich v. Jagiello (In re Jagiello* ), No. 12–4096, 2013 WL 4068166, at *6 (Bankr. E.D. Mich. Aug. 8, 2013)); *Hermoyian*, 466 B.R. at 380 ("actual fraud" requires proof of "intent, justifiable reliance, and proximate cause.") (citing *Field v. Mans*, 516 U.S. 59, 74–75, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995)).

[28]In *Field v. Mans*, 516 U.S. 59, 66, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) the Supreme Court stated:

> While § 523(a)(2)(A) speaks of debt for value "obtained by ... false pretenses, a false representation, or actual fraud," it does not define those terms or so much as mention the creditor's reliance as such, let alone the level of reliance required. No one, of course, doubts that some degree of reliance is required to satisfy the element of causation inherent in the phrase "obtained by[.]"

In *Field v. Mans*, without distinguishing between the three types of fraud under § 523(a)(2)(A), the Court held that the level of reliance necessary under § 523(a)(2)(A) is "justifiable, but not reasonable, reliance."[44] *Id.* at 74–75, 116 S.Ct. 437 (citations omitted); *see also Rembert*, 141 F.3d at 281 (listing the elements of nondischargeability under § 523(a)(2)(A), including justifiable reliance).

***16** Despite this, some cases decided after *Field v. Mans* held that "actual fraud" does not always require reliance by the creditor on anything the debtor said or did. But these cases were mostly like *Husky*, in that they did not involve inducement-based forms of fraud, such as a misrepresentation. *See, e.g., McClellan v. Cantrell*, 217 F.3d 890, 892–94 (7th Cir.2000) (case involved bankruptcy debtor's participation with her brother in a fraudulent conveyance scheme designed to thwart collection of a debt owed by the brother; court distinguished *Field v. Mans* and held that for "actual fraud," "reliance is relevant only when a fraud takes the form of a misrepresentation."); *Schafer v. Rapp (In re Rapp* ), 375 B.R. 421, 434 (Bankr. S.D. Ohio 2007) ("The fact patterns of [*Mellon Bank, N.A. v.*] *Vitanovich* [ *(In re Vitanovich* ), 259 B.R. 873 (B.A.P. 6th Cir. 2001)(check kiting scheme) ], and *McClellan* [*v. Cantrell*, 217 F.3d 890 (7th Cir.2000) ] illustrate that an objecting creditor need not in all cases demonstrate that the debtor made an express fraudulent representation—and that the creditor justifiably relied thereon—to obtain a judgment excepting a debt from discharge under § 523(a)(2)(A).").

This Court concludes that even after the Supreme Court's 2016 decision in *Husky*, justifiable reliance by the creditor *is* a necessary element of "actual fraud" under § 523(a)(2)(A), *when* the form of fraud is what *Husky* referred to as "inducement-based fraud." In this respect, *Husky* did not change prior law. This Court is bound by the Supreme Court's decision in *Field v. Mans*, and by the Sixth Circuit's decision in the *Rembert* case, cited above, both of which hold that all three types of fraud under § 523(a)(2)(A)—false representation; false pretenses; and actual fraud—require justifiable reliance. *Husky* changed that rule in only one respect, in holding that reliance is not required when the "actual fraud" is not an inducement-based fraud, but rather some other form of fraud such as a fraudulent conveyance scheme. At least one post-*Husky* case has taken this view of *Husky*, and this Court agrees with it. *See Argento v. Cahill (In re Cahill* ), No. 15-8298, 2017 WL 713565, at *7 (Bankr. E.D.N.Y. February 22, 2017) (noting that "[w]hile *Husky* expanded the definition of actual fraud to include more than fraud based on a misrepresentation, the Supreme Court clearly held that "actual fraud" also encompasses fraudulent inducement based on a misrepresentation;" and holding that under *Field v. Mans*, justifiable reliance is still required for "actual fraud" involving a misrepresentation.)

This view of *Husky* is consistent with the Supreme Court's discussion in *Husky* of *Field v. Mans.* The Supreme Court in *Husky* considered *Field v. Mans*, 516 U.S. 59, 66, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) "in which the Court noted that certain forms of bankruptcy fraud require a degree of direct reliance by a creditor on an action taken by a debtor." *Husky*, 136 S.Ct. at 1589. The *Husky* Court interpreted this statement in *Field v. Mans* to apply only to "fraud perpetrated through a misrepresentation." *See Husky*, 136 S.Ct. at 1589–90. The *Husky* Court stated:

> The dissent ... contend[s] that the phrase "obtained by ... actual fraud" requires not only that the relevant debts "resul[t] from" or be "traceable to" fraud but also that they "result from fraud *at the inception of a credit transaction.*" *Post*, at 1591 (emphasis added). Nothing in the text of § 523(a)(2)(A) supports that additional requirement. The dissent bases its conclusion on this Court's opinion in *Field*, in which the Court noted that certain forms of bankruptcy fraud require a degree of direct reliance by a creditor on an action taken by a debtor. But *Field* discussed such "reliance" only in setting forth the requirements of the form of fraud alleged in that case—namely, fraud perpetrated through a misrepresentation to a creditor. *See* 516 U.S. at 61, 116 S.Ct. 437. The Court was not establishing a "reliance" requirement for frauds that are not premised on such a misrepresentation.

***17** *Id.* (italics in original).

This Court's conclusion makes the most sense in light of both *Field v. Mans* and *Husky*. It makes sense to apply the same justifiable reliance requirement to all forms of inducement-based fraud, with respect to all three types of fraud listed in § 523(a)(2)(A) (false representation; false pretenses; actual fraud). And *Husky* does not hold otherwise. Actual reliance by the creditor is inherent in inducement-based fraud—*i.e.*, the creditor is induced to rely in some way to its detriment (*e.g.*, lending money) on the false representation or false impression created by the debtor's words, silence, or conduct. To require that such actual reliance be justifiable for purposes of "false representation" and "false pretenses" but not for purposes of "actual fraud" under § 523(a)(2)(A), does not make sense.

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# CHAPTER 7 ISSUES AND HOT TOPICS

CASE REOPENING AND PROPERTY OF THE ESTATE

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## CHAPTER 7 ISSUES AND HOT TOPICS

### CASE REOPENING AND PROPERTY OF THE ESTATE

Among the panoply of client data that bankruptcy counsel is obligated to analyze for the proposed debtor or for the trustee of a filed case is the question of what will be or is the property of a debtor's estate. Section 541 of the Bankruptcy Code provides that the estate will consist of "all legal or equitable interests of the debtor in property as of the commencement of the case." (11 U.S.C. § 541(a)(1)). "Property" includes causes of action possessed by a debtor at the time of filing of the case. (*United States v. Whiting Pools, Inc.,* 462 U.S. 198, 203, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983) at 205). As we have all come to understand, this seemingly straightforward proposition is fraught with complexity and nuance.

A number of recent Chapter 7 cases centering on causes of action as property of an estate illustrate this complexity.:

1. In ***In re Ross*, 548 B.R. 632 (Bankr. E.D. N.Y. 2016)**, a Chapter 7 Trustee moved to reopen a case more than 10 years after the discharge was granted after being notified that the debtor had been offered a settlement in exchange for waiving all present and future claims and causes of action related to a medical device that had been implanted in the debtor in 1998 (and removed in 1999), years before the filing of the bankruptcy in 2004.

It was stipulated that, at the time of the filing of the case, there was no reason to believe that the debtor had any problem resulting from the implanted device or from its removal and, in fact, had suffered no injury whatsoever, either pre-petition or post-petition.

The reopening of a closed case is governed by Section 350(b) of the Bankruptcy Code which provides: "A case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other cause." As noted in the *Ross* opinion, the statutory authorization is permissive and provides a court with broad discretion to determine whether relief should be granted. (*Ross*, 548 B.R. at 636). But reopening should be denied where the relief sought is not available, futile or a waste of judicial resources. *Id.* at 636.

In this case, the relief was dependent upon the determination of whether the claim to proposed settlement proceeds was property of the estate at the time of the filing of the petition.

Generally, pre-petition claims or causes of action belong to the estate while post-petition actions belong to the debtor. In *Segal v. Rochelle* (382 U.S. 375, 86 S. Ct. 511, 15 L. Ed. 2d 428 (1966)), a pre-Code case that remains a foundation analysis, the Supreme Court held that a tax refund received post-petition but based upon a pre-petition tax period was property of the estate because it was "sufficiently rooted in the pre-bankruptcy past" of the debtor. The Segal Court reasoned that, while the "enjoyment" of the refund was postponed to a time after the bankruptcy was closed, the debtor had a pre-petition right to it.

While the determination as to whether a debtor's interest in property is property of the estate is a question of federal law, the nature and extent of the debtor's rights in the property is controlled by state law. (*Booth v. Vaughan (In re Booth)*, 260 B.R. 281, 285 (B.A.P. 6th Cir. 2001) (citing *Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 918 (1979). Also see the recent 6th Circuit decision of *Town Center Flats, LLC v ECP Commercial II LLC (In re Town Center Flats, LLC)*, decided on May 2, 2017, File Number 16-1812.

After reviewing New York law, the court noted that if any element of the claim accrued post-petition, the debtor's interest in the settlement is not property of the estate even if the conduct giving rise to the claim took place pre-petition. "In cases such as this involving potential tort claims, the proper focus is on whether there was a viable cause of action the Debtor could bring under applicable law on the date the petition was filed. If an action existed, regardless of what the Debtor knew, then that cause of action and all its proceeds would constitute property of the estate. If, however, as is true in this case, no cause of action had matured, it is irrelevant whether the Debtor ultimately develops an injury: the cause of action resulting from that injury would not be property of the estate under § 541." (*Ross*, 548 B.R. at 635).

The court further went on to observe: “If the Court were to adopt the Trustee’s analysis, pre-petition exposure, without more, would be sufficient to create a pre-petition “legal or equitable interest.” Such analysis would expand property of the estate to include any interest so long as a trustee can tie such interest to a debtor’s “pre-bankruptcy past” and would transform section 341 meetings of creditors into health examinations. Opportunistic trustees would be scrambling to latch onto every possible claim that may someday arise, however attenuated.” (*Ross*, 548 B.R. at 640-641).

The motion to reopen was denied. The case is on appeal.

2. In another case from the Western District of Pennsylvania, ***Sikirica v. Harber (In re Harber)*****, 2016 Bankr. LEXIS 2168, No. 14-20155 (Bankr. W.D. Pa. May 31, 2016)**, the inquiry centered on when the claim accrued. Pre-petition, the debtor had two hip replacement surgeries using implants produced by DePuy Orthopaedics, one in 2007 and a second in 2008. Three years later, she received notice that some of the implants were problematic and she retained counsel and was listed among the plaintiffs in a class action lawsuit against DePuy.

An additional three years later, in January of 2014, the debtor and her husband filed for Chapter 7 relief. They listed the lawsuit in their schedules as a contingent, unliquidated claim with a value of $0. At that time, Ms. Harber had suffered no injury as a result of the implants.

The debtors were discharged and the bankruptcy case was closed with the potential claim against DePuy being excepted from the closing abandonment and the debtor being obligated to notify the trustee if and when the claim resulted in some recovery or offer to settle. The debtor then discovered that metal had entered her bloodstream due to the implants and she was advised to have the hip replacement revised. The class action claim was dismissed without prejudice and a new claim processed after the surgery. When the debtor’s bankruptcy attorney informed the trustee of a potential new claim and settlement offer against DePuy, the bankruptcy case was reopened and the trustee filed a turnover motion seeking to require the debtor to turnover any settlement to the bankruptcy estate.

The debtor objected arguing that any settlement would not be property of the estate because she did not suffer any injury until after the bankruptcy case was closed. Citing state law that a cause of action accrues only when one has an enforceable claim, the debtor argued that since she had no damages before the closing of the bankruptcy case, there existed no enforceable claim that would have been property of the estate. All the necessary elements of her negligence claim only existed after the bankruptcy was closed and, therefore, the claim belonged to her and not the estate.

The trustee argued that the *Segal v Rochelle* "sufficiently rooted" analysis should be applied. But the Court found that blind adherence to *Segal* would be contrary to the Supreme Court's decision in *Butner v. United States,* 440 U.S. 48 (1979), that property is determined with reference to state law, and the plain language of section 541(a).

The Couirt, therefore, adopted a blended test under which the state law governing accrual of an action would be considered along with the *Segal* "sufficiently rooted" test. Under this approach, a claim may be part of the bankruptcy estate if it is predominantly rooted in the debtor's pre-bankruptcy history, but by "happenstance" is not actionable until post-petition. Because the record did not indicate whether the injury was one that developed suddenly or over time, it was impossible to say that the injury existed prior to the debtor's discharge. The Court found that the existence of an injury was essential to the claim and was not present at the time of the bankruptcy petition. Therefore, the claim did not meet the requirements of property of the estate.

3. Timing was a seminal element in another case involving a cause of action founded in tortious interference. ***Robert D. Underhill & Beth Underhill v Huntington National Bank (In re Underhil),* 579 F. App'x 480 (6th Cir., 2014)** is an unreported case reversing a BAP decision in a 2-1 decision. The opinion and the dissent provide an excellent review of this aspect of property of the estate and further provide references to a additional number of 6th Circuit cases that would be helpful in wide understanding of the issue.

The Underhills filed for Chapter 7 protection in January of 2010, listing their 100% ownership interest in Golf Chic Boutique, LLC, as an asset. Three months after the debtors were discharged and the case closed, Golf Chic's major supplier cancelled its contract, leading to the company's failure. After discovering that a competitor had engaged in improper actions, Golf Chic sued for tortious interference with contract and disparagement. A settlement was reached and proceeds paid.

When Huntington Bank learned of the settlement, it filed a motion to reopen the bankruptcy case and allow the trustee to administer the proceeds to creditors asserting that the claim was an asset of the estate.

As in the previous cases, the court stated that "State substantive law determines the "nature and extent" of causes of action, *see Tyler v. DH Capital Mgmt., Inc.,* 736 F.3d 455, 461 (6th Cir. 2013), but federal bankruptcy law dictates when that property interest becomes property of the estate for purposes of § 541, *see In re Terwilliger's Catering Plus, Inc.,* 911 F.2d 1168, 1172 (6th Cir. 1990)."

Huntington argued that some testimony regarding a somewhat contentious business relationship pre-petition between Golf Chic and the supplier coupled with a state-court complaint that alleged that the business interference began a year before the bankruptcy provided sufficient Segal "roots" to make the claim property of the estate.

Quoting the *Tyler v DH Capital* case cited above, the Underhill Court agreed that pre-petition conduct or facts alone are not sufficient to "root" a claim in the past. Rather, there must be a pre-petition violation or injury. (*Underhill*, 579 F. App'x at 482) .

The dissent, referencing the same facts and law, concluded that sufficient "roots" did exist.

This highlights the unsettled nature of the Segal "roots" standard and suggests the difficulty of predicting the outcome of such property of the estate questions.