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Hotcakes and Hot Topics: Judges' Roundtable Q&A

Patrick A. Clisham, Moderator
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2018

JUDICIAL ROUNDTABLES Q&A SESSION

September 8, 2018

Moderator
Patrick A. Clisham
Engelman Berger, PC, Phoenix, AZ

Hon. Daniel P. Collins
U.S. Bankruptcy Court (D. Arizona)

Hon. Martin Barash
U.S. Bankruptcy Court (C.D. California)

Hon. Charles Novack
U.S. Bankruptcy Court (C.D.California)

Hon. Paul Sala
U.S. Bankruptcy Court (D. Arizona)

Hon. Madeleine C. Wanslee
U.S. Bankruptcy Court (D. Arizona)

Hon. Eugene R. Wedoff
U.S. Bankruptcy Court (N.D. Illinois - retired)

ABI CONFERENCE – SEPTEMBER 2018

JUDICIAL ROUNDTABLES

	JUDGE	TOPIC
1	**Paul Sala**	Does the Ninth Circuit holding in *Pinnacle Restaurant at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC),* 892 F.3d 892 (9th Cir. 2017) (debtor can use § 363(f)(1) to sell real property "free and clear" of all of a tenant's rights to occupy the property), expand a DIP/trustee's ability to complete sales "free and clear"?
2	**Eugene Wedoff**	Does § 362(a)(3) apply to cars repossessed before a Chapter 13 filing? A recent 10th Circuit decision, *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. 2017), holds that the stay does not require return of the car to the debtor. Every other circuit that's ruled on the question comes out the other way. I agree with the majority, and I have a Bankruptcy Law Letter that will come out this month dealing with the question.
3	**Madeleine Wanslee**	Marijuana related businesses/employment - how attenuated must the source of revenue be for access to the federal courts? (Not just landlords, growers, etc. but also the janitor of a dispensary that wants to file chapter 13 and fund a plan with his wages, etc.).
4	**Charles Novack**	The recent Ninth Circuit case of *In re Taggart*, 888 F.3d 438 (9th Cir. 2018), which discusses when a discharge injunction violation warrants a contempt finding.
5	**Daniel Collins**	Under what circumstances may a consumer debtor's lawyer bifurcate a fee agreement to pre and post payment of fees? This ties to a recent Dan Garrison article which appeared in the June 2018 ABI Journal.
6	**Martin Barash**	546(e) Safe Harbor — *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 200 L. Ed. 2d 183 (2018)

1. JUDGE PAUL SALA

Topic: Does the Ninth Circuit holding in *Pinnacle Restaurant at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC),* 892 F.3d 892 (9th Cir. 2017) (debtor can use § 363(f)(1) to sell real property "free and clear" of all of a tenant's rights to occupy the property), expand a DIP/trustee's ability to complete sales "free and clear"?

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872 F.3d 892
United States Court of Appeals,
Ninth Circuit.

In the MATTER OF SPANISH PEAKS HOLDINGS II, LLC, Debtor.
Pinnacle Restaurant at Big Sky, LLC; Montana Opticom, LLC, Plaintiffs-Appellants,
v.
CH SP Acquisitions, LLC; Ross P. Richardson, Ch. 7 Trustee, Defendants-Appellees.

No. 15-35572
|
Argued and Submitted April 6, 2017—Seattle, Washington
|
Filed July 13, 2017
|
Amended September 12, 2017

Synopsis

Background: Purchaser of estate property moved for clarification that it had acquired property free and clear of leasehold interests. The United States Bankruptcy Court for the District of Montana, Ralph B. Kirscher, J., 2014 WL 929701, granted motion, and appeal was taken. The District Court, No. 2:14-cv-00040-SEH, Sam E. Haddon, J., 2015 WL 3767099, affirmed. Appeal was taken.

[Holding:] The Court of Appeals, Block, Senior District Judge, sitting by designation, held that bankruptcy statute providing that, under appropriate circumstances, estate property may be sold free and clear of "any interest" was broad enough to permit sale of Chapter 7 debtor-lessor's property unencumbered by its tenants' leasehold interests, despite another bankruptcy statute that generally protected tenants' rights upon rejection of lease.

Affirmed.

West Headnotes (8)

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

On appeal in bankruptcy case, the Court of Appeals would review de novo bankruptcy court's decision on questions of statutory interpretation, such as whether leases survive a sale of estate property "free and clear" of interests. 11 U.S.C.A. § 363(f).

Cases that cite this headnote

[2] **Statutes** Other Statutes

Court must read statutes so as to give effect to each, if it can do so while preserving their sense and purpose.

Cases that cite this headnote

[3] **Bankruptcy** Assumption, Rejection, or Assignment

Rejection of debtor's unexpired lease or executory contract is an affirmative declaration by trustee that estate will not take on the obligations of the lease or contract. 11 U.S.C.A. § 365.

Cases that cite this headnote

[4] **Bankruptcy** Adequate protection; sale free of liens
Bankruptcy Effect of Acceptance or Rejection

Bankruptcy statute providing that, under appropriate circumstances, estate property may be sold free and clear of "any interest" was broad enough to permit sale of Chapter 7 debtor-lessor's property unencumbered by its tenants' leasehold interests, despite another bankruptcy statute that generally protected tenants' rights upon rejection of lease; sale free and clear was not a rejection of leases by trustee, so that this other statute was not implicated. 11 U.S.C.A. §§ 363(f), 365.

Cases that cite this headnote

[5] **Landlord and Tenant** Transfer or Termination of Landlord's Estate
Mortgages and Deeds of Trust Of Foreclosure Sale

Under Montana law, foreclosure sale to satisfy mortgage terminates a subsequent lease on the mortgaged property.

1 Cases that cite this headnote

[6] **Bankruptcy** Adequate protection; sale free of liens

Bankruptcy statute permitting sale of estate property free and clear of interests if "applicable nonbankruptcy law permits sale of such property free and clear of such interest[s]" does not require an actual or anticipated sale free and

clear under applicable nonbankruptcy law, but is satisfied if such a sale would be legally permissible. 11 U.S.C.A. § 363(f)(1).

2 Cases that cite this headnote

[7] **Bankruptcy** Adequate protection; sale free of liens

"Applicable nonbankruptcy law," as that term was used in bankruptcy statute that permitted sale of estate property free and clear of interests if "applicable nonbankruptcy law permit[ed] sale of such property free and clear of such interest[s]," was broad enough to include the law governing foreclosure sales, where state law provided that foreclosure sale to satisfy mortgage terminated a subsequent lease on the mortgaged property. 11 U.S.C.A. § 363(f)(1).

1 Cases that cite this headnote

[8] **Bankruptcy** Effect of Acceptance or Rejection

While bankruptcy statute dealing with debtor's executory contracts and unexpired leases evinces a Congressional intent to protect lessees, that intent is not absolute, but exists alongside other purposes and sometimes conflicts with them. 11 U.S.C.A. § 365.

Cases that cite this headnote

***894** Appeal from the United States District Court for the District of Montana, Sam E. Haddon, Senior District Judge, Presiding. D.C. No. 2:14-cv-00040-SEH

Attorneys and Law Firms

Mark A. Lindsay (argued) and David W. Ross, Babst Calland Clements and Zomnir P.C., Pittsburgh, Pennsylvania, for Plaintiffs-Appellants.

James F. Wallack (argued) and Peter D. Bilowz, Goulston & Storrs PC, Boston, Massachusetts; Steven M. Johnson, Church Harris Johnson & Williams P.C., Great Falls, Montana; for Defendants-Appellees.
Before: Alex Kozinski and William A. Fletcher, Circuit Judges, and Frederic Block, District Judge.*

OPINION

BLOCK, Senior District Judge:

The primary function of the Bankruptcy Code is to set out the rules for dividing up assets that are insufficient to pay a debtor's creditors in full. One such rule, contained in 11 U.S.C. § 363(f), authorizes a trustee in bankruptcy to sell—with some exceptions and limitations—a debtor's assets free and clear of third-party interests. Another, contained in 11 U.S.C. § 365(h), empowers the trustee to "reject"—that is, in effect, to breach—an unexpired lease of the debtor's property, but allows the lessee to retain any existing rights, including possession of the property.

In this case, we are called upon to decide what happens when property that the trustee proposes to sell is subject to unexpired leases. We hold that, on the facts of this case, section 363 applies and section 365 does not. We therefore affirm the bankruptcy court's conclusion that the sale was free and clear of the leases.

I

A. Pre-Bankruptcy Background

Spanish Peaks was a 5,700-acre resort in Big Sky, Montana, the brainchild of James J. Dolan, Jr., and Timothy L. Blixseth. The project was financed by a $130 million loan, which was secured by a mortgage and assignment of rents, from Citigroup Global Markets Realty Corp. ("Citigroup"). Citigroup later assigned the note and mortgage to Spanish Peaks Acquisition Partners, LLC ("SPAP").

A collection of interrelated entities owned the resort and managed its amenities, including a ski club, a golf course, and residential and commercial real-estate sales and rentals. At issue here are two leases of commercial property at the resort.

In 2006, Spanish Peaks Holdings, LLC ("SPH"), leased restaurant space to Spanish Peaks Development, LLC ("SPD"), for $1,000 per month. Dolan was an officer of both companies, and signed the lease for both lessor and lessee. A year later, SPH and SPD replaced the 2006 lease with a lease under which SPD received a 99-year leasehold in the restaurant property in exchange for $1,000 per year in rent. In 2008, SPD assigned its interest to The Pinnacle Restaurant at Big Sky, LLC ("Pinnacle"), a company specially created for that purpose.

***895** In 2009, SPH leased a separate parcel of commercial real estate at the resort to Montana Opticom, LLC ("Opticom"), of which Dolan was the sole member. The lease had a term of sixty years and an annual rent of $1,285.

B. Bankruptcy Proceedings

Facing a shrinking real-estate market and mounting operational losses, SPH began to default on its loan payments. On October 14, 2011, SPH and two related entities—The Club at Spanish Peaks, LLC, which managed the resort's ski and golf facilities, and Spanish Peaks Lodge, LLC, which managed its real-estate sales—petitioned for bankruptcy protection under Chapter 7 of the Code.[1] The petitions were filed in Delaware, but the proceedings were transferred to the Bankruptcy Court for the District of Montana, where they were consolidated for joint administration.

SPH's largest creditor was, by far, SPAP, which had a valid claim of more than $122 million secured by the mortgage on the property. SPAP subsequently assigned its interest to CH SP Acquisitions, LLC ("CH SP").

The trustee and SPAP agreed to a plan for liquidating "substantially" all of the debtors' real and personal property. Their stipulation contemplated an auction with a minimum bid of $20 million. It further stated that the sale would be "free and clear of all liens."

The trustee then moved the bankruptcy court for an order authorizing and approving the sale.[2] The trustee represented that the proposed sale would be "free and clear of any and all liens, claims, encumbrances and interests," except for certain specified encumbrances, and that other specified liens would be paid out of the proceeds of the sale or otherwise protected.

The Pinnacle and Opticom leases were not mentioned in either the list of encumbrances that would survive the sale or the list of liens for which protection would be provided. Noting the omission, both companies objected to "any effort to sell the Debtors[']s assets free and clear of [their] leasehold interests." They argued that the Code gave them the right to retain possession of the property notwithstanding the sale.

After a hearing, the bankruptcy court authorized the sale. It did not rule on Pinnacle's and Opticom's objection. Instead, further discussion of the claimed right to possession was deferred to the hearing on the motion to approve the sale.

Both the auction and the approval hearing took place on June 3, 2013. CH SP won the auction with a bid of $26.1 million. At the approval hearing, Pinnacle and Opticom renewed their claim that they were entitled to retain possession pursuant to their leases, and argued that language in the proposed approval order providing that the sale would be free and clear of those interests was inconsistent with their claimed right. In response, CH SP's principal testified that its bid was contingent on the property being free and clear of the leases, while the trustee testified that he did not "t[ake] a position" on that issue.

***896** On June 13, 2013, the bankruptcy court entered an order approving the sale. Paragraph I of the order held that the sale was free and clear of any "Interests," a term defined to include any leases "(except any right a lessee may have under 11 U.S.C. § 365(h), with respect to a valid and enforceable lease, all as determined through a motion brought before the Court by proper procedure)."

Both sides moved for clarification of the approval order. Pinnacle and Opticom sought clarification that the order preserved their rights under the leases, while CH SP sought clarification that the order approved a sale free and clear of those interests. The bankruptcy court denied having ruled one way or the other, explaining that it would not consider the issue until the parties had "file[d] an appropriate motion, notice[d] the matter for hearing, and present [ed] their evidence."

The trustee then offered his version of an "appropriate motion," seeking leave to reject the Pinnacle and Opticom leases on the ground that the subject property was no longer property of the estate. CH SP, meanwhile, formally moved for a determination that the property was free and clear of the leases. Pinnacle and Opticom did not object to the trustee's motion, which was granted. They did, however, renew their previous arguments as objections to CH SP's motion.

After a two-day evidentiary hearing on that motion, the bankruptcy court made the following findings of fact:

- Pinnacle had not operated a restaurant on the property since 2011;
- Pinnacle's rent was far below the property's fair market rental value of $40,000 to $100,000 per year;
- Opticom's lease was not recorded;
- the leases were executed "at a time when all parties involved were controlled by James J. Dolan";
- the leases were the subject of bona fide disputes;

- Citigroup's mortgage was senior to the leases; and

- the leases were not protected from foreclosure of the underlying mortgage by subordination or non-disturbance agreements.

It further observed that Pinnacle and Opticom had not requested adequate protection for their leasehold interests prior to sale, and had at no time provided any evidence that they would "suffer any economic harm if their possessory interests [we]re terminated."

Based on those findings, the bankruptcy court—applying what it called a "case-by-case, fact-intensive, totality of the circumstances, approach"—held that the sale was free and clear of the Pinnacle and Opticom leases. Pinnacle and Opticom appealed to the district court, which affirmed.[3] In a brief opinion, the district court held that the sale extinguished the leases because the foreclosure of a mortgage would, under Montana law, terminate any leasehold interests junior to the mortgage. This appeal followed.

II

[1]The principal issue is whether the Pinnacle and Opticom leases survived the sale of the property to CH SP.[4] Because ***897** that issue is ultimately one of statutory interpretation, we review the bankruptcy court's decision de novo. *See Simpson v. Burkart (In re Simpson)*, 557 F.3d 1010, 1014 (9th Cir. 2009); *Robertson v. Peters (In re Weisman)*, 5 F.3d 417, 419 (9th Cir. 1993) ("We independently review the bankruptcy court's decision and do not give deference to the district court's determinations.").

As we noted at the outset, the issue brings two sections of the Code into apparent conflict. Section 363 authorizes the trustee to sell property of the estate, both within the ordinary course of business, *see* 11 U.S.C. § 363(c), and outside it, *see id.* § 363(b).[5] Sales may be "free and clear of any interest in such property of an entity other than the estate," *id.* § 363(f), but only if

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Id. Upon the request of a party with an interest in the property, the bankruptcy court "shall prohibit or condition such ... sale ... as is necessary to provide adequate protection of such interest." *Id.* § 363(e).

Meanwhile, section 365 of the Code authorizes the trustee, "subject to the court's approval," to "assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). Subsection (h) makes special provision for rejected leases under which the debtor is the lessor:

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease

> may treat such lease as terminated by the rejection; or
>
> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

***898** The crux of this dense statutory language is that the rejection of an unexpired lease leaves a lessee in possession with two options: treat the lease as terminated (and make a claim against the estate for any breach), or retain any rights—including a right of continued possession—to the extent those rights are enforceable outside of bankruptcy.

The statutes frequently operate in isolation. Many bankruptcies will involve a sale of property unencumbered by a lease, and many will involve the rejection of a lease on property that the trustee does not intend to sell. But when both provisions come into play—that is, when the trustee proposes to sell property free and clear of encumbrances, and one of the encumbrances is an unexpired lease—federal courts have addressed the resulting dilemma in different ways.

A. The "Majority" Approach

Several bankruptcy courts have held that sections 363 and 365 conflict when they overlap because "each provision seems to provide an exclusive right that when invoked would override the interest of the other." *In re Churchill Props.*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996); *see also In re Haskell, L.P.*, 321 B.R. 1, 8–9 (Bankr. D. Mass. 2005); *In re Taylor*, 198 B.R. 142, 164–66 (Bankr. D.S.C. 1996); *cf. In re LHD Realty Corp.*, 20 B.R. 717, 719 (Bankr. S.D. Ind. 1982). Those courts—which constitute a majority of the courts to have addressed the issue—hold that section 365 trumps section 363 under the canon of statutory construction that "the specific prevails over the general." *In re Churchill Props.*, 197 B.R. at 288. They further reason that "the legislative history regarding § 365 evinces a clear intent on the part of Congress to protect a tenant's estate when the landlord files bankruptcy," *In re Taylor*, 198 B.R. at 165 (citing S. Rep. No. 95-989, at 60 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5846), and that the protection "would be nugatory," *In re Churchill Props.*, 197 B.R. at 288, if the property could be sold free and clear of the leasehold under section 363.

B. The "Minority" Approach

The only circuit court to have addressed the issue reached a different conclusion based exclusively on the statutory text. In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.)*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit observed that "the statutory provisions themselves do not suggest that one supersedes or limits the other." *Id.* at 547.

The court then examined the scope of each statute. Section 363, it reasoned, confers a right to sell property free and clear of "any interest," without excepting from that authority leases entitled to the protections of section 365. *See id.* Section 365, by contrast, has a more "limited scope":

> Section 365(h) ... focuses on a specific type of event—the rejection of an executory contract by the trustee or debtor-in-possession—and spells out the rights of parties affected by that event. It says nothing at all about sales of estate property, which are the province of section 363.

Id.

Again focusing on the statutory text, the court noted that lessees are entitled to seek "adequate protection" under section 363(e). "Lessees ... are therefore not without recourse in the event of a sale free and clear of their interests. They have the right to seek protection under section 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected." 327 F.3d at 548.

***899** Based on the statutes" different scopes, the court concluded that they did not conflict:

> Where estate property under lease is to be sold, section 363 permits the sale to occur free and clear of a lessee's possessory interest—provided that the lessee (upon request) is granted adequate protection for its interest. Where the property is not sold, and the [estate] remains in possession thereof but chooses to reject the lease, section 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees.

Id.

C. Our Approach

[2]We must "read the statutes to give effect to each if we can do so while preserving their sense and purpose." *Watt v. Alaska*, 451 U.S. 259, 267, 101 S.Ct. 1673, 68 L.Ed.2d 80 (1981). We can easily do so here. Based on our reading—and, in particular, a proper understanding of the concept of "rejection"—we agree with the Seventh Circuit that sections 363 and 365 do not conflict.

[3]Although undefined in the Code, a "rejection" is universally understood as an affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor. *See, e.g.*, *Eastover Bank for Sav. v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1082 (5th Cir. 1994). A sale of property free and clear of a lease may be an effective rejection of the lease in some everyday sense, but it is not the same thing as the "rejection" contemplated by section 365.

[4]In sum, section 363 governs the sale of estate property, while section 365 governs the formal rejection of a lease. Where there is a sale, but no rejection (or a rejection, but no sale), there is no conflict.

In some circumstances, a trustee's failure to act is deemed a rejection. *See* 11 U.S.C. §§ 365(d)(1) (failure to assume or reject residential lease within sixty days in liquidation bankruptcy deemed a rejection), 365(d)(4)(A) (failure to assume or reject nonresidential lease within 120 days deemed a rejection if the debtor is the lessee). But those circumstances are not present here, and the parties agree that the Pinnacle and Opticom leases were not "rejected" prior to the sale. Under our interpretation, then, section 365 was not triggered.[6]

We base our interpretation principally on the reasons given by the Seventh Circuit. To that court's sound textual analysis, we add the following observations to mitigate the concern that an attempt to harmonize the two statutes "arguably results in the effective repeal of § 365(h)." *Dishi & Sons*, 510 B.R. at 704.

First, we note the mandatory language of section 363(e). A bankruptcy court *must* provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it. Moreover, "adequate protection" includes any relief—other than compensation as an administrative expense—that will "result in ***900** the realization by such entity of the indubitable equivalent" of the terminated interest. 11 U.S.C. § 361(3). In *Dishi & Sons*, the district court concluded that adequate protection could take the form of continued possession. *See* 510 B.R. at 711–12. Since Pinnacle and Opticom did

not ask for adequate protection until after the sale had taken place—not, indeed, until they had appealed to the district court, *see supra* note 2—the question of what protection the bankruptcy court could have or should have awarded is not before us. Still, we think it worth mentioning that the broad definition of adequate protection makes it a powerful check on potential abuses of free-and-clear sales.

Second, we emphasize that section 363(f) authorizes free-and-clear sales only in certain circumstances. The bankruptcy court did not specify which circumstance justified the sale in this case, stating only that Pinnacle and Opticom "d[id] not dispute that at least one provision of § 363(f) was satisfied." We, on the other hand, focus on 11 U.S.C. § 363(f)(1), which authorizes a sale if "applicable nonbankruptcy law permits sale of such property free and clear of such interest." 11 U.S.C. § 363(f)(1).

[5] [6]Under Montana law, a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property. *See Ruby Valley Nat'l Bank v. Wells Fargo Delaware Trust Co.*, 373 Mont. 374, 317 P.3d 174, 178 (2014); *Williard v. Campbell*, 91 Mont. 493,11 P.2d 782, 787 (1932).[7] SPH's bankruptcy proceeded, practically speaking, like a foreclosure sale—hardly surprising since its largest creditor was the holder of the note and mortgage on the property. Indeed, had SPH not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale. Such a sale would have terminated the Pinnacle and Opticom leases. Section 363(f)(1) does not require an actual or anticipated foreclosure sale. It is satisfied if such a sale would be legally permissible.

[7]In *Dishi & Sons*, the district court held that section 363(f)(1) "refers not to foreclosure sales, but rather only to situations where the owner of the asset may, under nonbankruptcy law, sell an asset free and clear of an interest in such asset." 510 B.R. at 710 (citation and internal quotations omitted). While we acknowledge that bankruptcy protection is often sought "for the very purpose of avoiding the less favorable consequences of foreclosure," *id.* at 709, the protection is generally for the debtor's benefit. We find it significant that section 365 recognizes appurtenant rights conferred by a lease "to the extent that such rights are enforceable under applicable nonbankruptcy law," 11 U.S.C. § 365(h)(1)(A)(ii), and discern from that language a clear intent to protect lessees' rights outside of bankruptcy, not an intent to enhance them. We see no reason to exclude the law governing foreclosure sales from the analogous language in section 363(f)(1).

[8]Our analysis highlights a limitation inherent in the "majority" approach. We agree that section 365 embodies a congressional intent to protect lessees. But that intent is not absolute; it exists alongside other purposes and sometimes conflicts with them. To some extent, protecting lessees reduces the value of the estate—property presumably fetches a lower price if it is subject to a lease—and is therefore contrary ***901** to the goal of "maximizing creditor recovery," *Qualitech*, 327 F.3d at 548, another core purpose of the Code. The statutory text is the best assurance we have that we are balancing competing purposes in the way Congress intended.

III

Section 363(f)(1) authorized the sale of SHP's property free and clear of the Pinnacle and Opticom leases. Since the trustee did not reject the leases, section 365 was not implicated. Accordingly, the judgment of the district court is

AFFIRMED.

All Citations

872 F.3d 892, 77 Collier Bankr.Cas.2d 2039, Bankr. L. Rep. P 83,157, 17 Cal. Daily Op. Serv. 8997

Footnotes

[*] The Honorable Frederic Block, Senior United States District Judge for the Eastern District of New York, sitting by designation.

[1] By the time of the bankruptcy, the resort was operated by Spanish Peaks Holdings II, LLC, a successor to SPH. We refer to both the original and successor entities as "SPH."

[2] Bankruptcy procedure is nothing if not Byzantine. The trustee's motion sought two distinct orders: first, an order *authorizing* the trustee to conduct the sale in accordance with specified procedures, and second, an order *approving* the sale—that is, confirming that the sale conformed to those procedures.

[3] In addition, Pinnacle and Opticom moved the bankruptcy court for an order awarding them monetary compensation as "adequate protection" for their "divested interests" in the property. The bankruptcy court never ruled on that motion.

[4] In reaching the merits, we reject CH SP's argument that the case is moot because the sale was approved and consummated. "The reversal or modification on appeal of an authorization ... of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal." 11 U.S.C. § 363(m). By its terms, section 363(m) preserves *the validity* of a sale challenged on appeal. Although Pinnacle and Opticom seek a determination that their leaseholds survived the sale to CH SP, they have not asked us to undo the sale. Therefore, the outcome of the appeal will not affect the sale's validity.

[5] Sales in the ordinary course of business do not require prior notice and court approval, while sales outside the ordinary course of business do. *Compare* 11 U.S.C. § 363(c) *with id.* § 363(b). The sale of SPH's property was outside the ordinary course of business.

[6] It is, of course, possible for a trustee to formally reject a lease and then propose to sell the property subject to the (rejected) lease. *See Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696, 704 (S.D.N.Y. 2014) (noting that *Qualitech* "conveniently" dealt with a situation "where a free and clear sale occurred without any formal assumption or rejection taking place"). That is not what happened here, and so we have no occasion to address the interplay between sections 363 and 365 in such circumstances.

[7] Montana law embodies the general rule of property law, except that Montana law allows the tenant to remain in possession during any period of redemption, while under the general rule the lease terminates immediately upon the sale. *See Williard*, 11 P.2d at 787. The distinction is immaterial for our purposes.

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Losing Your Lease: Ninth Circuit Permits Stripping Leasehold Interests Under § 363(f)

Angelo M. Castaldi
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What happens when property of the estate that a trustee or debtor-in-possession proposes to sell "free and clear" is subject to unexpired lease interests? The resolution of this question requires the reconciliation of two separate provisions of the Bankruptcy Code that most often operate independently and in isolation. The first provision, 11 U.S.C. § 363(f), permits a trustee or debtor in possession [1] in bankruptcy to sell assets of the estate free and clear of third-party interests. The second provision, § 365(h), permits a debtor in possession or trustee to reject an unexpired lease of property of the estate, with the lessee retaining the option of treating the entire lease as terminated or remaining in possession of the property.

Ninth Circuit Takes Up the Issue: *In re Spanish Peaks Holdings II, LLC* [2]

The debtors in *Spanish Peaks* were a collection of interrelated companies that owned a 5,700-acre resort in Big Sky, Mont., and managed its amenities, which included several residential and commercial real estate rentals. [3] After the real estate market contracted and the operational losses of the debtors mounted, the debtors each filed for chapter 7 relief. [4] The chapter 7 trustee of the debtors' consolidated bankruptcy estate and the debtors' largest creditor developed a "plan" for liquidating substantially all of the debtors' real and personal property — including two commercial properties subject to an unexpired lease (the "leases") — "free and clear of all liens." [5]

Objecting to the trustee's motion to sell substantially all of the debtors' assets "free and clear," the lessees under the leases argued that the Bankruptcy Code authorized them to retain possession of the leased properties notwithstanding the proposed sale. [6] The bankruptcy court, after multiple hearings, eventually entered an order providing that the sale of the debtors' assets was free and clear of the lessees' interests under the leases.

After the district court affirmed the ruling of the bankruptcy court on appeal, the lessees appealed to the Ninth Circuit.

The Apparent Clash of §§ 363 and 365

As noted at the outset of this article, the *Spanish Peaks* court was called to reconcile two sections of the Bankruptcy Code that were in apparent conflict: §§ 363 and 365. Section 363 generally provides for the use, sale or lease of property belonging to the bankruptcy estate. As relevant for the *Spanish Peaks* court, subsections (b) and (c) authorize the trustee to sell estate property either within the normal course of a debtor's business (in which case, the sale may take place without prior notice and a hearing) or outside the normal course of business (in which case, the sale must take place upon notice and hearing).

Section 363(f) makes apparent that such property may be sold unencumbered by third-party interests if one of five conditions is met: [7]

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if —

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Section 363(e) further provides that, upon request from a party with an interest in the property to be sold, the court, with or without a hearing, shall prohibit or condition such ... sale ... as is necessary to provide adequate protection of such interest." [8] This may entail a cash payment, an additional or replacement lien, or other relief sufficient to result in the realization by such entity of the indubitable equivalent of such entity's interest in such property. [9] Together, § 363 makes clear that a debtor in possession or trustee may sell property of the estate outside the normal course of business after notice and a hearing, and such sale may be free and clear of interests held by others if one of five conditions is met. In turn, any party with an interest in the property may request adequate protection as a condition to such sale.

Meanwhile, § 365(h) governs the rejection of leases of a debtor/lessor by the trustee or debtor in possession. [10] Section 365 authorizes the trustee to assume or reject unexpired leases or executory contracts of the debtor, subject to court approval. [11] Under this section, "rejection" is tantamount to an election *not* to obligate the estate on a contract or lease and gives rise to a remedy for breach of contract in the non-debtor party. [12] Section 365(h) makes special provision for the remedies available to a lessee when the debtor is the lessor by affording the lessee the option of (1) treating the entire lease as terminated and making a claim against the estate for any breach or (2) retaining its appurtenant rights under the lease, including the right of continued possession. [13]

Although §§ 363 and 365(h) generally operate harmoniously in isolation, [14] when applied concomitantly the disparate analyses undertaken by courts, including *Spanish Peaks*, highlight that the reconciliation of the provisions can be quite a difficult task.

The "Majority," "Minority" and Ninth Circuit Approaches

In *Spanish Peaks*, through Judge Frederic Block, [15] the Ninth Circuit "easily" resolved the issue on appeal, holding that § 363(f) authorizes the sale of estate property free and clear of the unexpired leasehold interests. [16] In reaching this conclusion, the Ninth Circuit identified and rejected the "majority approach" adopted by several bankruptcy courts, which provides that the protections to lessees under § 365 trumps the right to reject unexpired leases under § 363. [17] Under this "majority approach," §§ 363(f) and 365(h) are effectively irreconcilable when applied together and therefore hold that a trustee's only options under these circumstances are to either assume the lease or reject the lease subject to the special remedies provided for under § 365(h). [18]

Instead, the Ninth Circuit sided with the approach taken by the Seventh Circuit — the only circuit to have addressed the issue presented. In its opinion, [19] the Seventh Circuit relied exclusively on statutory text to determine that neither §§ 363 nor 365 "suggest that one supersedes or limits the other." [20] Indeed, § 363 authorizes the trustee or debtor-in-possession to sell property free and clear of "any interest" and does not except the protections provided for under § 365(h) from that authority. [21] Under this minority approach, § 363(f) authorizes a debtor/lessor to bypass § 365(h) and sell its interest in estate property free and clear of the leasehold interest, with the lessee retaining its right to seek adequate protection under § 363(e). [22]

Adding to the Seventh Circuit's "minority approach," the *Spanish Peaks* court elaborated that a sale of property free and clear of a lease is *not* tantamount to "rejection" under the Bankruptcy Code, and therefore, "[w]here there is a sale, but no rejection (or a rejection, but no sale), there *is no conflict*." [23] Further, § 363(e) incorporates a *mandatory* remedy for lessees when there is a sale but no rejection: adequate protection, which "could take the form of continued possession." [24] Therefore, under *Spanish Peaks*, although § 365(h) embodies a congressional intent to protect lessees, such an intent is not absolute and must exist alongside other competing policy norms of the Bankruptcy Code, such as maximizing the value of the estate for distribution to creditors.

Takeaway

Whether you are involved in a bankruptcy case in a district that has adopted the majority or minority positions set forth above, *Spanish Peaks* serves as a reminder to attorneys who represent lessees to undertake basic protectionary measures within the context of the bankruptcy case. First, such attorneys should timely seek adequate protection under § 363(e) should their client's leasehold interest be subject to a sale conducted by a trustee or debtor in possession under § 363(f). Such adequate protection is *mandatory* and may include compensation for the value of its leasehold from the proceeds of the sale, [25] continued possession of the leased premises, [26] or some other relief that will "'result in the realization by such entity of the indubitable equivalent' of the terminated interest." [27] Second, such attorneys should also object to any such sale and specifically target the factors set forth in § 363(f) in order to test whether the § 363(f) sale is appropriate under the circumstances.

The reasoning of the Ninth Circuit in *Spanish Peaks* and the Seventh Circuit in *Qualitech* nonetheless constitute a potentially potent tool in the toolkit of debtors in possession and trustees.

[1] 11 U.S.C. § 902(5) ("trustee" generally means "debtor" in Chapter 9 cases); 11 U.S.C. § 1107(a) (granting a Chapter 11 debtor in possession the rights, powers, and duties otherwise provided for the trustee under the Bankruptcy Code); 11 U.S.C. § 1203 (same for Chapter 12 debtor); 11 U.S.C. § 1303 (same for Chapter 13 debtor).

[2] No. 15-35572, 2017 WL 4156370 (9th Cir. September 12, 2017).

[3] *Id.* at *1.

[4] *Id.*

[5] *Id.*

[6] *Id.* at *2-3.

[7] Section 363(f) is written in the disjunctive, and if any of the five conditions are met, the debtor has the authority to conduct the sale free and clear of all liens. *In re Kellstrom Indus., Inc.*, 282 B.R. 787, 793 (Bankr. D. Del. 2002).

[8] 11 U.S.C. § 363(e); *see also* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 545 (7th Cir. 2003).

[9] *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 701 (S.D.N.Y. 2014) (citing *Qualitech Steel*, 327 F.3d at 545).

[10] *In re Churchill Properties III Ltd. P'ship*, 197 B.R. 283, 287 (Bankr. N.D. Ill. 1996).

[11] 11 U.S.C. § 365(a).

[12] *In re Lavigne,* 114 F.3d 379, 387 (2d Cir. 1997).

[13] 11 U.S.C. § 365(h)(1); *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 702 (S.D.N.Y. 2014).

[14] *See Dishi*, 510 B.R. at 702 (describing separate application of provisions as "straightforward"); Pinnacle Restaurant at *Big Sky, LLC v. CH SP Acquisitions, LLC* (*In re Spanish Peaks Holdings II, LLC*), No. 15-35572, 2017 WL 4156370, at *1 (9th Cir. September 12, 2017).

[15] Judge Block, Senior U.S. District Judge for the Eastern District of New York, sat by designation.

[16] *Spanish Peaks*, 2017 WL 2979660, at *7.

[17] *See, e.g.*, *Id.* at *4.

[18] *See Dishi*, 510 B.R. at 702 (citing and analyzing cases reflecting "majority" approach).

[19] *Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.)*, 327 F.3d 537 (7th Cir. 2003).

[20] *Id.* at 547.

[21] *Id.*

[22] *Spanish Peaks*, 2017 WL 2979660, at *5–6; *Precision Industries*, 327 F.3d at 548.

[23] *Spanish Peaks*, 2017 WL 2979660, at *5–6.

[24] *Id.*

[25] *Precision Indus. Inc. v. Qualitech Steel SBQ LLC*, 327 F.3d 537, 548 (7th Cir. 2003).

[26] *Spanish Peaks Holdings,* 2017 WL 2979660, at *5–6; *Dishi & Sons*, 510 B.R. at 711-12.

[27] *Spanish Peaks Holdings*, 2017 WL 2979660, at *5–6.

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2. JUDGE EUGENE WEDOFF

Topic: Does § 362(a)(3) apply to cars repossessed before a Chapter 13 filing? A recent 10th Circuit decision, *WD Equipment v. Cowen* (*In re Cowen*), 849 F.3d 943 (10th Cir. 2017), holds that the stay does not require return of the car to the debtor. Every other circuit that's ruled on the question comes out the other way. I agree with the majority, and I have a Bankruptcy Law Letter that will come out this month dealing with the question.

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By Eugene R. Wedoff

The Automatic Stay Under § 362(a)(3)—One More Time

One of most significant issues in consumer bankruptcy currently in dispute is whether § 362(a)(3) of the Bankruptcy Code requires creditors to return to a debtor any collateral—most commonly automobiles—that they repossessed before the bankruptcy filing. In 1984, subsection (a)(3) was amended. Before the amendment, it only applied the automatic stay to "any act *to obtain possession* of property of the estate or of property from the estate," and so only prevented creditors from seizing a debtor's property during the bankruptcy case. The 1984 amendment expanded the provision by extending the stay to apply to any act "*to exercise control* over property of the estate." Debtors used this amendment to argue that after the filing of a bankruptcy case, § 362(a)(3) not only prevented creditors from seizing the debtor's property, but also prohibited them from continuing to hold whatever property they had seized earlier, since by retaining what was now estate property, they would be exercising control over it.

The initial response to this argument was a string of circuit court and BAP decisions agreeing with the debtors, establishing a majority rule that creditors were indeed stayed by § 362(a)(3) from continuing to hold estate property repossessed before a debtor's bankruptcy filing and that they were required to return that property to a debtor otherwise entitled to it.[1] This string was unbroken until last year,[2] when the Tenth Circuit issued *WD Equipment v. Cowen*, holding § 362(a)(3) imposes no duty on creditors to return repossessed collateral.[3]

One notable aspect of the new circuit split is that *Cowen's* rejection of the majority rule cites a *Bankruptcy Law Letter* written by Professor Ralph Brubaker in 2013.[4] With the issuance of *Cowen,* and a set of related questions about the automatic stay, another look at the issues raised in that *Law Letter* may be timely.

The majority rationale

The majority interpretation of § 362(a)(3) is based on plain language. The Second Circuit's decision made the point this way:

> [S]ection 362 forbids any act to … "exercise control" over the property of the estate. We need consult only an ordinary dictionary to confirm that a typical definition of "control" is: "To exercise authority over; direct; command." Webster's New World College Dictionary (4th ed. 2002). In light of that definition, we see no way to avoid the conclusion that, by keeping custody of the vehicle and refusing [the debtor] access to or use of it, [the secured creditor] was "exercising control" over the object in which the estate's equitable interest lay, and its retention of the vehicle violated the stay.[5]

The decision found additional linguistic support in the nature of the 1984 amendment, pointing out that "obtaining possession" of estate property held by the debtor had already been stayed, so that "exercising control" had to mean something more. "This significant textual enlargement is consonant with our understanding … that Congress intended to prevent

creditors from retaining property of the debtor … without regard to what party was in possession of the property in question when the petition was filed."[6]

The minority rationale

The 2013 *Law Letter* is probably the most complete statement challenging the majority interpretation of § 362(a)(3).[7] The *Law Letter* sets out four grounds for questioning the majority interpretation. Each of these grounds, however, can itself be questioned.

1. Upholding established law

The *Law Letter's* initial argument is based on the Supreme Court's *Dewsnup* rationale: that an established principle of bankruptcy law should not be interpreted as changed by an amendment unless the change is set out unambiguously or supported by legislative history.[8] This approach to statutory construction has been widely criticized, as even the Supreme Court has noted.[9] But applying the approach here is problematic in any event, since it is difficult to see the bankruptcy principle that is contradicted by interrupting a creditor's exclusive possession of estate property. The *Letter* suggests that creditors were only required to return collateral to debtors after a court determined that their interests would be adequately protected: "adequate protection before turnover."[10] But under the Bankruptcy Code, adequate protection was not automatically required. It always had to be requested.[11]

Before the 1984 expansion of § 362(a)(3), if a creditor was unwilling to return collateral, the debtor would have to seek a court order requiring turnover under § 542(a), and in response the creditor could request adequate protection under § 363(e). Only if the creditor made that request could it be said that adequate protection was a prerequisite for turnover.[12] The 1984 amendment, in prohibiting a creditor from retaining collateral sought by a debtor, did not change the secured creditor's right to adequate protection under § 363(e), it only changed the party with possession of the property during the time that the court considered a creditor's request for protection.

That change can be seen as consistent with the general operation of the automatic stay. Before the 1984 amendment, the stay took away a creditor's nonbankruptcy right to repossess collateral when the debtor was in default under a secured loan; the debtor was allowed to keep collateral until the court determined, in ruling on a creditor's motion for relief from the stay, that there was a lack of adequate protection. The amendment resulted in the same status being applied to property that was repossessed before the bankruptcy. Rather than changing a fundamental bankruptcy policy, the amendment can be seen as extending the basic policy underlying the stay: that the debtor should be able to use all estate property until the creditor requests relief.

The majority decisions reflect this understanding, as set out in the Seventh Circuit's *Thompson* decision:

> The primary goal of reorganization bankruptcy is to group all of the debtor's property together in his estate such that he may rehabilitate his credit and pay off his debts; this necessarily extends to all property, even property lawfully seized prepetition. See Whiting Pools, Inc., 462 U.S. at 203-04, 103 S.Ct. 2309; see also In re Yates, 332 B.R. 1, 5 (10th Cir. BAP 2005) ("As a practical matter, there is little difference between a creditor who obtains property of the estate before bankruptcy is filed, or after bankruptcy is filed. The ultimate result is the same—the estate will be deprived of possession of that property. This is precisely the result § 362 seeks to avoid.''). An asset actively used by a debtor serves a greater purpose to both the debtor and his creditors than an asset sitting idle on a creditor's lot.[13]

2. The meaning of an "act to exercise control"

The *Law Letter* next suggests that the phrase "acts to exercise control over estate property" is in fact ambiguous—"extremely vague"—and cites in support the *Inslaw* decision of the D.C. Circuit.[14] But the ambiguity addressed by *Inslaw* was whether, by refusing to pay damages on a claim asserted by the debtor, a creditor was engaging in an exercise of control.[15] *Inslaw*

found this application of § 362(a)(3) unsupportable.[16] But this is not an indication of a difficulty in understanding the meaning of exercising control over property; rather, the question was the nature of the property involved. An estate's cause of action is property of the estate; the recovery that a debtor hopes to obtain from the cause of action is not estate property. In *Citizens Bank v. Strumpf,* the Supreme Court made exactly this distinction in holding that a bank's temporary freeze on a depositor's account did not violate § 362(a)(3). The provision might have been violated, the Court said, if the bank had "exercised dominion over property" as it would have "if a bank account consisted of money belonging to the depositor and held by the bank."[17]

> In fact, however, [a bank account] consists of nothing more or less than a promise to pay, from the bank to the depositor, and [the bank's] temporary refusal to pay was neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise.[18]

Inslaw, then, gives no basis for finding that § 362(a)(3) is ambiguous.

But even if there were some difficulty in measuring the full extent of exercising control over estate property, the question would remain: why is a creditor holding exclusive possession of estate property not exercising control over it? The *Law Letter* answers this question by quoting dicta in *Inslaw*: "The automatic stay, as its name suggests, serves as a restraint only on acts to gain possession or control over property of the estate,'' and suggests that § 362(a)(3) cannot apply if "a creditor does nothing and simply retains possession of property that the creditor already has in its possession."[19] The difficulty with this argument is apparent from the Inslaw quotation, which speaks of "gaining" rather than "exercising" control. While "gain" refers to a past achievement ("[t]o come into possession or use of; acquire"), "exercise,"-the statutory term-refers to ongoing activity ("[t]o put into play or operation, employ").[20] The plain meaning of exercising control in § 362(a)(3) applies to continuing exclusive possession of collateral.

The Tenth Circuit's *Cowen* decision not only accepts the limitation of § 362(a)(3) suggested in the *Law Letter* but adds another argument about the provision's meaning, asserting that because the word "act" means "doing something," § 362(c)(2) "stays entities from doing something to obtain possession of or to exercise control over the estate's property" rather than "passively holding onto an asset," as the Seventh Circuit stated in *Thompson*.[21] But, of course, the creditors in each of the majority decisions did "do something"—they prevented the debtors from obtaining access to the collateral. Although each creditor's action was not new, it was an ongoing, continuing exercise of control, and so proscribed by the statutory language.

Moreover, if exercising control over estate property did not include maintaining exclusive possession of the property, there would be the question of what it does include. It cannot mean selling the property or otherwise using it to reduce the creditor's claim, since § 362(a)(6) separately stays any act "to collect, assess, or recover a claim against the debtor." The *Law Letter* suggests that if the nondebtor party to an executory contract terminates the contract of the estate, it will be exercising control over estate property, and cites a Ninth Circuit decision, *In re Computer Communications*, in support of that interpretation.[22] However, Computer Communications held that terminating the contract was an "act to obtain possession of property of the estate," not an act to exercise control.[23]

Finally, the *Law Letter* suggests that if someone not in possession of estate assets files a lawsuit that belongs to the estate, the filing could be seen as exercising control over an estate asset. Again, though, this is more likely to be seen as obtaining possession of the asset. And even if one or more of these hypothetical applications of exercising control were reasonable, it is difficult to imagine that they were a significant enough problem in 1984 that Congress would specially legislate to address them. The common meaning of exercising control over a piece of property—holding it to the exclusion of others—is not only the plain meaning of the amendment but is the only meaning addressing an issue significant enough to prompt legislation.

3. The meaning of "property of the estate"

The Law Letter continues its statutory construction by turning to the meaning of "property of the estate." It cites an article by Professor Thomas Plank arguing that when the Bankruptcy Code uses the term "property of the estate," it does not mean "property" in the ordinary sense—individual items or pieces of property—but rather the particular property interests that the debtor holds at the time the bankruptcy case is filed.[24] With this understanding, the *Law Letter* reasons (1) that the "property

of the estate"—over which a creditor may not exercise control under § 362(a)(3)—does not include the right of possession, since the debtor did not have that right at the time the case was filed and (2) that to bring that right into the estate, the debtor would have to obtain turnover under § 542(a).[25]

The difficulty with this argument is in its premise. Apart from the bankruptcy court decision in *Hall,* which cites the *Law Letter* extensively,[26] no judicial decision appears to accept Professor Plank's understanding of "property of the estate," and this understanding is inconsistent with the manner in which the Bankruptcy Code uses the term. One example of the difficulty is § 363(f), which allows the sale of property under § 363(b) and (c), free and clear of "any interest in such property of an entity other than the estate" if one of a set of conditions is met, including that the interest of the other party is in bona fide dispute.[27] Subsections (b) and (c) only provide for sales of "property of the estate," and so, at least in § 363, the Code uses that term to mean the entire property to which the debtor claims title, even if another party is in possession at the time of filing or holds a bona fide claim of interest adverse to the debtor. With this understanding of property of the estate, the debtor's entire property is similarly subject to the protection of § 362(a)(3).

4. The balance of harms

Finally, the *Law Letter* compares the different costs imposed on debtors and creditors under the conflicting interpretations of § 362(a)(3).[28] For creditors, it says, returning collateral on demand by a debtor, as required by the majority interpretation, will likely result in—

(a) the complete loss of any possessory lien,
(b) the risk of full loss of value in uninsured collateral through theft or accidental damage, and
(c) the deprivation of compensation for the value lost through depreciation or the expense of seeking an order granting adequate protection.

These costs would be removed under the minority interpretation because it requires the debtor to file a turnover proceeding to regain possession of collateral, and, if demanded by the creditor, the debtor would have to prove adequate protection before turnover was granted.

For debtors, the *Law Letter* acknowledges the cost imposed by the minority interpretation: they will be unable to use a vehicle (or other collateral) that may be needed for work, schooling, and health care until the court rules on turnover, and the period of deprivation may be a long one—the time needed to file and obtain emergency relief in the adversary proceeding mandated by Fed. R. Bankr. P. 7001(1) for turnover under § 522(a). The majority interpretation of § 352(a)(3), by allowing debtors to obtain immediate return of the collateral without a turnover proceeding, removes this cost.

Although this balance shows harm to parties under both interpretations, the *Law Letter* suggests that the greater harm is imposed by the majority interpretation:

> A well-advised debtor … would *never* offer *any* adequate protection in demanding turnover and would *always* put the secured creditor to the burden of moving for stay relief/adequate protection before the bankruptcy court, or use the prospective burden of doing so as leverage in adequate protection negotiations, but only *after* securing turnover *without* providing *any* adequate protection, which (as we've seen) holds the (not unrealistic) prospect of entirely eviscerating the secured creditor's right to receive adequate protection.[29]

Accordingly—and consistent with its view of the difficulties it sees with the majority interpretation—the only recommendation that *Law Letter* makes for improving the law on return of collateral is a rule change that would allow debtors prompter access to turnover.[30]

The balance set out by the *Law Letter,* however, may need adjustment. Although its description of harm to debtors is accurate, its view of the harm to creditors appears to be overstated in each of the respects it discusses.

(a) ***Possessory liens are not eliminated by § 362(a)(3).***

Possessory liens generally terminate when the creditor holding the lien loses possession of the collateral.[31] For this reason the

Law Letter sees the majority interpretation of § 362(a)(3)—requiring creditors to give up the collateral they possess—as resulting in the loss of any possessory lien.[32] It criticizes the Eighth Circuit BAP's opinion in *In re WEB2B Payment Solutions, Inc.*, which deals with a possessory lien, for bending the majority rule by suggesting that a possessory lien holder could withhold surrender of the collateral "until the bankruptcy court is able to make a determination as to whether, and to what extent, the creditor is entitled to adequate protection."[33] That suggestion, the *Law Letter* states, cannot be reconciled with the majority decisions, including the Eighth Circuit's opinion in *Knaus*, which allow for no exceptions to return of collateral under § 362(a)(3).[34]

But there are two problems with the idea that § 362(a)(3) would cause the loss of a possessory lien. The first is that, under the common law, a possessory lien only terminates when the creditor loses possession if the creditor gives up possession voluntarily. The Restatement of Security explains this in a comment:

> The lien is a legal interest dependent upon possession. Where the lienor voluntarily gives up the possession, his lien, at least so far as it is a legal interest, is gone. The lienor … does not lose his legal interest if he is deprived without his consent of his possession either by the bailor [owner] or a third person. If the lienor's surrender of possession is voluntary but obtained by fraud, the lienor can recover the chattel unless third persons in the meantime have acquired interests. Where possession is taken without the consent of the lienor, even a bona fide purchaser is subject to the lien, provided the chattel is non-negotiable.[35]

Accordingly, a retention lien continues to apply to collateral even if a legal obligation required the creditor to return it.[36]

The *WEB2B* decision reflects this rule. The collateral in the case was cash of a Chapter 7 debtor that a creditor had received subject to a possessory lien. The trustee requested that the creditor turnover all of the cash. Under an agreement with the trustee, and without any proceeding in the bankruptcy court, the creditor retained what it considered a sufficient amount of cash to satisfy its claims against the debtor and gave the balance to the trustee. Later, the retained collateral proved insufficient to cover these claims, and the creditor argued that the transferred collateral had been given to the trustee under compulsion, so that the possessory lien should continue to apply to it, citing the Supreme Court's *Whiting Pools* decision under § 542(a) to argue that the Bankruptcy Court should have determined what adequate protection would apply to the continuing lien. The BAP rejected this argument, holding that the transfer was voluntary, so that the possessory lien terminated when the collateral was transferred.[37] The BAP did suggest that the creditor could have requested a court determination of adequate protection before turning over the property, but this was plainly dicta. If payment to the trustee had actually been compelled, rather than voluntary, so that the possessory lien continued in place, the creditor would have been able to seek a ruling on adequate protection after the transfer. The BAP, however, had no reason to consider the effect of an involuntary transfer on possessory liens, whether made pursuant to § 362(a)(3) or any other provision of law; indeed, § 362(a)(3) is not mentioned in the decision.

The second problem with the *Law Letter's* treatment of possessory liens is that if nonbankruptcy law did result in termination of the lien after an involuntary transfer, an exception to the automatic stay—§ 362(b)(3)—would prevent § 362(a)(3) from going into effect, and the creditor would not be required to give up possession. This exception to the stay was explained in a decision of the Ninth Circuit BAP, *Hayden v. Wells.*[38] In that case, Chapter 13 debtors relied on § 362(a)(3) to obtain the return of their vehicle from a company with a possessory lien for its services in towing and storing the automobile. The BAP held that the § 363(b) stay exception required denial of the debtors' request, and explained the exception's effect:

> [I]f state law provides that a creditor's security interest is superior to the rights of any entity obtaining its interest in the property prior to the date the creditor takes action to maintain or continue perfection of its lien, the creditor's post-petition act to maintain or continue perfection of the lien does not violate the automatic stay. Boggan v. Hoff Ford, Inc. (In re Boggan), 251 B.R. 95, 99 (9th Cir. BAP 2000) (holding that automobile dealership that retained possession of debtor's automobile as security for repayment of unpaid repair bill pursuant to Idaho law did not violate automatic stay).[39]

A recent decision by the Bankruptcy Court for the Northern District of Illinois, *In re Avila*, cited *Hayden* in holding that

362(b)(3) permits the City of Chicago to retain vehicles impounded for traffic violations because return of the vehicle under § 362(a)(3) would terminate the City's possessory lien for the impounding; the Seventh Circuit's *Thompson* decision was held inapplicable because of the § 363(b)(3) stay exception.[40] No appeal was taken from this order, but other judges in the Northern District of Illinois have disagreed with its holding, one ruling that the municipal ordinance granting the City's lien exceeds the City's police power,[41] and the other ruling that § 363(b)(3) "applies only to 'acts' taken by creditors" and "passive possession of a debtor's property for the purposes of maintaining possession does not constitute an 'act.' "[42] These decisions have been appealed, and the appeals are pending in the district court.

But the *Hayden* and *Avila* decisions can be questioned on grounds other than those set out in the Chicago appeals. If applicable nonbankruptcy would not result in termination of a possessory lien after the lienholder was compelled to surrender possession, then there would be no need for the lienholder to retain possession in order to maintain or continue perfection of its lien, and the stay exception would not apply. The possessory lien would be given no different treatment than a purchase money lien. But in determining the effect of § 362(a)(2) on possessory liens, it is plain that regardless of whether the lien remains effective under the common law or under the § 362(b)(3) stay exception, the creditor does not lose its lien.

(b) ***Transfers of uninsured vehicles may be prevented by annulment of the automatic stay.***

It is also unlikely that § 362(a)(3) will require creditors to return uninsured vehicles to debtors. In addition to allowing a creditor to seek termination or modification of the automatic stay for a lack of adequate protection, § 362(d)(1) allows the stay to be annulled. Annulment has been consistently understood as retroactively terminating the stay, and so validating whatever action would otherwise have been a stay violation.[43] Although there is a lack of consistency in the language used by the courts discussing the grounds for stay annulment, there is general agreement that a balancing of the interests of the parties is required.[44] Among the factors that have generally been considered in this balancing are the good faith of the debtor in seeking enforcement of the stay and the harm to the creditor if the stay is enforced.[45] Courts may also grant annulment "if grounds for relief from the stay existed and a motion, if filed, would likely have been granted prior to the automatic stay violation [and] if failure to grant retroactive relief would cause unnecessary expense to the creditor."[46]

Under this precedent, if a creditor that had repossessed an uninsured car was faced with a demand by a Chapter 13 debtor to return the car under § 362(a)(2), the creditor could refuse until the debtor obtained insurance, and if the debtor sought to hold the creditor in violation of the automatic stay, the creditor could file a motion for annulment of the stay and almost certainly prevail.[47] By attempting to obtain use of a vehicle without insurance, the debtor would be acting in bad faith; if the creditor had been able to present a motion for stay relief, it would have been granted; and the harm to the creditor if the stay were enforced would be the potential loss of the full value of its security interest.[48]

Of course, the creditor would still have to incur the expense of seeking stay annulment if the debtor charged the creditor with a stay violation. But since the courts would routinely grant such annulment motions, the debtor would have little reason to seek enforcement of § 362(a)(3); the cost of drafting and presenting the motion for stay enforcement would be wasted.

(c) ***Chapter 13 provides substantial protection against declines in the value of collateral, without the need for creditor action.***

The remaining harm that the *Law Letter* sees imposed by the majority interpretation of § 362(a)(3) is the loss of value in a repossessed vehicle that would occur while the debtor uses the vehicle without having to the provide adequate protection that could have been ordered by the court, without a motion by the creditor, if the debtor had been required to seek a turnover under § 524(a). In Chapter 13, however, adequate protection is automatically required of any debtor holding collateral from the outset of the case; no creditor action is required. Section 1326(a)(1)(C) requires adequate protection payments to the secured creditor, unless the court orders otherwise, commencing no later than 30 days after the case is filed. It is unlikely that if debtors were required to file adversaries seeking turnover, the courts would order more in adequate protection than such payments. And to comply with the payment requirement would be grounds for stay relief and even dismissal of the case.[49]

All of this suggests that the balance of harms resulting from the two interpretations of § 362(a)(3) is different from that set out in the 2013 *Law Letter*. While the minority interpretation does indeed impose substantial costs on debtors unable to use

their vehicles, the majority interpretation does not impose costs on creditors to the extent that the *Law Letter* suggests.

Potential resolution of the circuit conflict

Because the *Cowen* case was remanded for further proceedings (which could involve the imposition of sanctions on the creditors) there is no possibility, at least immediately, of Supreme Court review. The *Cowen* interpretation of § 362(a), however, might be subject to fuller consideration by the Tenth Circuit itself. In a Chapter 7 case in the District of Kansas, *Davis v. Tyson Prepared Foods*, an issue arose that the bankruptcy judge found similar to the question in *Cowen*.[50] In *Davis*, a worker was injured on the job and sought workers compensation benefits, but after filing a bankruptcy case, also filed a state court complaint against the company that supplied the item that caused her injury and obtained a judgment against that supplier. Under Kansas law, the employer was subrogated to the worker's right to recover from the supplier to the extent of the employer's workers compensation payments to her, and a lien supporting this subrogation attaches to the judgment against the supplier.[51]

Does the attachment of this lien violate the automatic stay? If so, the estate would be entitled to the judgment, and the trustee has so argued. The bankruptcy court, however, held that the lien did not violate the automatic stay, because though the lien attached postpetition, it did so automatically, with no "act" violating the stay. The Tenth Circuit has granted direct review of this decision, and a decision applying *Cowen* is likely, but whatever decision is reached by the panel, a petition for en banc review or certiorari, challenging *Cowen,* seems likely.

Conclusion

Because of the large number of Chapter 13 cases in which an automobile of the debtor has been repossessed, the question whether the automatic stay requires return of vehicle will remain an important one. As set out in the 2013 *Law Letter* and in this one, it is also a complicated one.

Footnotes

[1] See In re Knaus, 889 F.2d 773, 775, 19 Bankr. Ct. Dec. (CRR) 1691, Bankr. L. Rep. (CCH) P 73117 (8th Cir. 1989); In re Del Mission Ltd., 98 F.3d 1147, 1151-52, 29 Bankr. Ct. Dec. (CRR) 1155, 36 Collier Bankr. Cas. 2d (MB) 1658, Bankr. L. Rep. (CCH) P 77176, 36 Fed. R. Serv. 3d 512 (9th Cir. 1996) (expressly adopting the reasoning of In re Abrams, 127 B.R. 239, 241-43, 21 Bankr. Ct. Dec. (CRR) 1283, 25 Collier Bankr. Cas. 2d (MB) 15, Bankr. L. Rep. (CCH) P 74023 (B.A.P. 9th Cir. 1991), holding that failure to return a repossessed car after receiving notice of the debtor's bankruptcy violated § 362(a)(3)); Thompson v. General Motors Acceptance Corp., LLC, 566 F.3d 699, 703, 61 Collier Bankr. Cas. 2d (MB) 1611, Bankr. L. Rep. (CCH) P 81490 (7th Cir. 2009); and In re Weber, 719 F.3d 72, 81, 69 Collier Bankr. Cas. 2d (MB) 1168, Bankr. L. Rep. (CCH) P 82484 (2d Cir. 2013). Accord, In re Yates, 332 B.R. 1, 54 Collier Bankr. Cas. 2d (MB) 1901, 8 A.L.R. Fed. 2d 837 (B.A.P. 10th Cir. 2005) (abrogated by, In re Cowen, 849 F.3d 943, 63 Bankr. Ct. Dec. (CRR) 211, 77 Collier Bankr. Cas. 2d (MB) 438 (10th Cir. 2017)); In re Sharon, 234 B.R. 676, 1999 FED App. 0009P (B.A.P. 6th Cir. 1999); In re Carrigg, 216 B.R. 303, 31 Bankr. Ct. Dec. (CRR) 1324, Bankr. L. Rep. (CCH) P 77657 (B.A.P. 1st Cir. 1998). See also In re Rozier, 348 F.3d 1305 (11th Cir. 2003), certified question answered, 278 Ga. 52, 597 S.E.2d 367, 54 U.C.C. Rep. Serv. 2d 31 (2004), and In re Rozier, 376 F.3d 1323, 1324, Bankr. L. Rep. (CCH) P 80137 (11th Cir. 2004) (requiring return of collateral obtained prepetition as long as the collateral remained estate property after repossession).
Because § 362(a)(3) applies only to estate property, however, these decisions do not require return of collateral to debtors who are not entitled to possess estate property—including all Chapter 7 debtors. Any right to receive repossessed property in Chapter 7 cases would belong to the trustee. In re Perry, 540 B.R. 710, 725 (Bankr. C.D. Cal. 2015), aff'd in part, rev'd in part, 2017 WL 1276075 (C.D. Cal. 2017) ("If a creditor fails to turn over the debtor's property, the [Chapter 7] debtor cannot bring actions under § 362(a)(3) prior to the debtor's exemption in the assets being perfected, because such actions may only be brought by the trustee. After the exemption revests the property in the debtor, the debtor cannot bring a § 362(a)(3) action because the asset is then no longer property of the estate."). In this *Law Letter*, "debtor" is used to mean a debtor entitled to possession of estate property.

[2] The only arguably inconsistent circuit decision issued before 2017 is U.S. v. Inslaw, Inc., 932 F.2d 1467, 21 Bankr. Ct. Dec. (CRR) 1077, Bankr. L. Rep. (CCH) P 74056, 37 Cont. Cas. Fed. (CCH) P 76104 (D.C. Cir. 1991), which held that a creditor—the United States Department of Justice—was not required to return to the debtor computer programming material whose ownership was in dispute, reasoning that a party claiming ownership of property could not be required to surrender the property to a debtor with a competing ownership claim before the ownership dispute was adjudicated. In that context, the court stated both that "it is difficult to believe that Congress intended a [stay] violation whenever someone already in possession of property mistakenly refuses to capitulate to a bankrupt's assertion of rights in that property" and that the stay "serves as a restraint only on acts to gain possession or control over property of the estate," rather than "creat[ing] an affirmative duty to remedy past acts of fraud or bias or harassment." Id. at 1473-74. *Inslaw* did not consider whether § 362(a)(3) requires the return of collateral when the debtor's ownership of the property is undisputed, and indeed cites *Knaus*, the leading case so holding, for the rule that "turnover of property admitted to belong to the debtor is required." 932 F.2d at 1472.

[3] In re Cowen, 849 F.3d 943, 63 Bankr. Ct. Dec. (CRR) 211, 77 Collier Bankr. Cas. 2d (MB) 438 (10th Cir. 2017). The facts in *Cowen* make it a somewhat unattractive case for upsetting the rule requiring repossessed collateral to be returned to debtors. The vehicle involved in the case was a truck that a Chapter 13 debtor used in his business and was subject to a purchase money security interest held by another individual, Bert Dring. The circuit court opinion explains how the truck came to be repossessed:

> Mr. Dring lured Mr. Cowen under false pretenses to his place of business to repossess the Kenworth [truck]. Mr. Dring asked Mr. Cowen, who had brought along his young son, to leave the keys in the ignition, engine running, and to step out of the truck. As Mr. Cowen exited the vehicle, Mr. Dring jumped in, grabbed the keys, and declared the truck "repossessed." When Mr. Cowen asked what was going on, Mr. Dring told him to take his son and leave—immediately. A group of five men gathered around Mr. Dring while he brandished a can of mace above his head and threatened to use it if Mr. Cowen did not leave. Mr. Cowen pushed his young son behind him to protect him, and the two left the lot on foot.

Id. at 945. After Cowen filed a Chapter 13 bankruptcy case, Dring objected to any bankruptcy treatment of the truck. The decision explains:

> Mr. Dring claimed that he sold the Kenworth sometime prior to the bankruptcy filing. (Initially, he claimed he had sold the Kenworth to an unknown Mexican national for cash in an undocumented sale just days before Mr. Cowen filed for bankruptcy. Later, Mr. Dring produced bill of sale, purporting to show that he sold the Kenworth to a Mr. Garcia for $16,000 in cash on August 4 [two days before the bankruptcy filing]).

Id. at 946. The bankruptcy court found that Dring (and a relative involved in the repossession of another of Cowen's trucks) had probably forged documents, given perjured testimony, and coached witnesses during a hearing on the adversary proceeding that Cowen brought to enforce the automatic stay. Id.

[4] Cowen, 849 F.3d at 949-50, quoting Ralph Brubaker, Turnover, Adequate Protection, and the Automatic Stay (Parts I and II): Who Is ''Exercising Control'' Over What?, 33 Bankr. L. Letter Nos. 8-9 (Sept. & Aug. 2013).

[5] Weber v. SEFCU (In re Weber), 719 F.3d at 79. See also, Thompson, 566 F.3d at 702 (making the same point, citing a different dictionary).

[6] Weber v. SEFCU (In re Weber), 719 F.3d at 80.

[7] The 2013 *Law Letter* gives a much fuller set of reasons than *Cowen* does for rejecting the majority interpretation. For a judicial decision discussing these reasons and extensively citing the *Law Letter*, see In re Hall, 502 B.R. 650, 59 Bankr. Ct. Dec. (CRR) 6 (Bankr. D. D.C. 2014).

[8] Brubaker, 33 Bankr. L. Letter No. 9 at 8-9, citing Dewsnup v. Timm, 502 U.S. 410, 419, 112 S. Ct. 773, 116 L. Ed. 2d 903, 22 Bankr. Ct. Dec. (CRR) 750, 25 Collier Bankr. Cas. 2d (MB) 1297, Bankr. L. Rep. (CCH) P 74361A (1992).

[9] See Bank of America, N.A. v. Caulkett, 135 S. Ct. 1995, n.1, 192 L. Ed. 2d 52, 61 Bankr. Ct. Dec. (CRR) 31, 73 C.B.C. 1485, Bankr. L. Rep. (CCH) P 82807 (2015):

> From its inception, Dewsnup v. Timm, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903 (1992), has been the target of criticism. See, e.g., id., at 420-436, 112 S. Ct. 773 (Scalia, J., dissenting); In re Woolsey, 696 F. 3d 1266, 1273-1274, 1278 (CA10 2012); In re Dever, 164 B. R. 132, 138, 145 (Bkrtcy. Ct. CD Cal. 1994); Carlson, Bifurcation of Undersecured Claims in Bankruptcy, 70 Am. Bankr. L. J. 1, 12-20 (1996); Ponoroff & Knippenberg, The Immovable Object Versus the Irresistible Force: Re-thinking the Relationship Between Secured Credit and Bankruptcy Policy, 95 Mich. L. Rev. 2234, 2305-2307 (1997); see also Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Part-nership, 526 U.S. 434, 463, 119 S. Ct. 1411, 143 L. Ed. 2d 607, and n. 3 (1999) (Thomas, J., concurring in judgment) (collecting cases and ob-serving that "[t]he methodological confusion created by Dewsnup has enshrouded both the Courts of Appeals and . . . Bankruptcy Courts").

[10] Brubaker, 33 Bankr. L. Letter No. 9 at 2.

[11] See 11 U.S.C.A. § 363(e), providing for adequate protection "on request of an entity that has an interest in [estate] property"; U.S. v. Whiting Pools, Inc., 1983-2 C.B. 239, 462 U.S. 198, 204, 103 S. Ct. 2309, 2313, 76 L. Ed. 2d 515, 10 Bankr. Ct. Dec. (CRR) 705, 8 Collier Bankr. Cas. 2d (MB) 710, Bankr. L. Rep. (CCH) P 69207, 83-1 U.S. Tax Cas. (CCH) P 9394, 52 A.F.T.R.2d 83-5121 (1983) ("At the secured creditor's insistence, the bankruptcy court must place such limits or conditions … as are necessary to protect the creditor.").

[12] See In re R. Purbeck & Associates, Ltd., 12 B.R. 406, 408 (Bankr. D. Conn. 1981) ("[A] secured creditor may insist upon adequate protection as a condition precedent to the turnover of property since the property may not be used, sold or leased under section 363 without it.").

[13] Thompson, 566 F.3d at 702.

[14] Brubaker, 33 Bankr. L. Letter No. 9 at 3, citing Inslaw, 932 F.2d at 1474. The clarity of the1984 amendment to § 362(a)(3) is a critical question under the *Dewsnup* approach to statutory construction. There is no relevant legislative history for the 1984 amendment to § 362(a)(3), but *Dewsnup* recognizes that this cannot defeat the effect of clear statutory language. See Dewsnup, 502 U.S. at 419-20, 112 S. Ct. at 779 ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling.").

[15] Inslaw, 932 F.2d at 1472 (defining the "property" at issue as the debtor's "intangible trade secret rights" and the asserted "exercise of control" as the use of these rights contrary to the parties' contract).

[16] Inslaw, 932 F.2d at 1472 ("Whenever a party against whom the bankrupt holds a cause of action (or other intangible property right) acted in accord with his view of the dispute rather than that of the debtor-in-possession or bankruptcy trustee, he would risk a determination by a bankruptcy court that he had 'exercised control' over intangible rights (property) of the estate.")

[17] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 21, 116 S. Ct. 286, 290, 133 L. Ed. 2d 258, 28 Bankr. Ct. Dec. (CRR) 97, 33 Collier Bankr. Cas. 2d (MB) 869, Bankr. L. Rep. (CCH) P 76666A (1995).

[18] Strumpf, 516 U.S. 16, 21, 116 S. Ct. 286, 290 (1995).

[19] Brubaker, 33 Bankr. L. Letter No. 9 at 3, quoting Inslaw, 932 F.2d at 1474.

[20] American Heritage College Dictionary 556, 479 (3d ed. 1997)

21 Cowen, 849 F.3d at 949, quoting New Oxford American Dictionary 15 (3d ed. 2010) and Thompson, 566 F.3d at 703.

22 Brubaker, 33 Bankr. L. Letter No. 9 at 4, citing In re Computer Communications, Inc., 824 F.2d 725, 16 Bankr. Ct. Dec. (CRR) 615, 17 Collier Bankr. Cas. 2d (MB) 556, Bankr. L. Rep. (CCH) P 71933 (9th Cir. 1987).

23 Computer Communications, 824 F.2d at 728.

24 Brubaker, 33 Bankr. L. Letter No. 9 at 4-5, citing Thomas E. Plank, The Outer Boundaries of the Bankruptcy Estate, 47 Emory L.J. 1194, 1209, 1213 (1998).

25 Brubaker, 33 Bankr. L. Letter No. 9 at 5.

26 Hall, 502 B.R. at 667.

27 Precision Industries, Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 544, 41 Bankr. Ct. Dec. (CRR) 65, 49 Collier Bankr. Cas. 2d (MB) 1765, Bankr. L. Rep. (CCH) P 78836 (7th Cir. 2003) summarizes the operation of § 362(f) this way:

> Section 363 generally provides for the use, sale, or lease of property belonging to the bankruptcy estate. [S]ubsections (b) and (c) permit the trustee of a bankruptcy estate to sell estate property either within the normal course of a debtor's business (in which case the sale may take place without prior notice and a hearing) or outside the normal course of business (in which case … notice and hearing are mandatory). Subsection (f) makes clear that the property, under specified conditions, may be sold unencumbered of interests held by others … .

28 Brubaker, 33 Bankr. L. Letter No. 9 at 6-9.

29 Brubaker, 33 Bankr. L. Letter No. 9 at 7-8.

30 Brubaker, 33 Bankr. L. Letter No. 9 at 9.

31 In re Borden, 361 B.R. 489, 494, 62 U.C.C. Rep. Serv. 2d 158 (B.A.P. 8th Cir. 2007) ('[P]ossession is generally required for a possessory lien.").

32 Brubaker, 33 Bankr. L. Letter No. 9 at 6-7.

33 In re WEB2B Payment Solutions, Inc., 488 B.R. 387, 393, 57 Bankr. Ct. Dec. (CRR) 202, Bankr. L. Rep. (CCH) P 82449 (B.A.P. 8th Cir. 2013).

34 Brubaker, 33 Bankr. L. Letter No. 9 at 8.

35 Restatement of Security § 80 cmt. c (1941). Among the decisions applying this common law rule is Finch v. Miller, 531 P.2d 892, 893 (Or. 1975)(en banc) (holding that a possessory lien was not lost by the debtors' removing the collateral from the creditor's possession without the creditor's consent).

36 See Gangloff Industries, Inc. v. Generic Financing and Leasing, Corp., 907 N.E.2d 1059, 69 U.C.C. Rep. Serv. 2d 113 (Ind. Ct. App. 2009) (holding that a possessory lien continued in effect after the secured creditor had given up possession of the collateral pursuant to an erroneous court order).

37 WEB2B, 488 B.R. at 393.

[38] In re Hayden, 308 B.R. 428, 51 Collier Bankr. Cas. 2d (MB) 1688, Bankr. L. Rep. (CCH) P 80084 (B.A.P. 9th Cir. 2004).

[39] Hayden, 308 B.R. at 432.

[40] In re Avila, 566 B.R. 558, 560, 77 Collier Bankr. Cas. 2d (MB) 709 (Bankr. N.D. Ill. 2017).

[41] In re Howard, 584 B.R. 252 (Bankr. N.D. Ill. 2018).

[42] In re Fulton, 2018 WL 2392854 (Bankr. N.D. Ill. 2018), opinion amended and superseded, 2018 WL 2570109 (Bankr. N.D. Ill. 2018)

[43] See, e.g., In re Siciliano, 13 F.3d 748, 751, 30 Collier Bankr. Cas. 2d (MB) 667, Bankr. L. Rep. (CCH) P 75656 (3d Cir. 1994) In re Schwartz, 954 F.2d 569, 573, 22 Bankr. Ct. Dec. (CRR) 845, 26 Collier Bankr. Cas. 2d (MB) 649, Bankr. L. Rep. (CCH) P 74539, 92-1 U.S. Tax Cas. (CCH) P 50069, 69 A.F.T.R.2d 92-548 (9th Cir. 1992); Sikes v. Global Marine, Inc., 881 F.2d 176, 178-79, 19 Bankr. Ct. Dec. (CRR) 1224, Bankr. L. Rep. (CCH) P 73061 (5th Cir. 1989) (rejected by, In re Servico, Inc., 144 B.R. 933, 23 Bankr. Ct. Dec. (CRR) 687, 27 Collier Bankr. Cas. 2d (MB) 1239, Bankr. L. Rep. (CCH) P 74936 (Bankr. S.D. Fla. 1992)); In re Albany Partners, Ltd., 749 F.2d 670, 675, 12 Bankr. Ct. Dec. (CRR) 787, 12 Collier Bankr. Cas. 2d (MB) 244, Bankr. L. Rep. (CCH) P 70184 (11th Cir. 1984) (rejected by, In re Victoria Ltd. Partnership, 187 B.R. 54, 27 Bankr. Ct. Dec. (CRR) 1210, Bankr. L. Rep. (CCH) P 76666 (Bankr. D. Mass. 1995)).

[44] See In re Myers, 491 F.3d 120, 129, 48 Bankr. Ct. Dec. (CRR) 133, Bankr. L. Rep. (CCH) P 80962 (3d Cir. 2007) ("Even those cases that have subscribed to a narrow conception of the power to retroactively annul the stay have affirmed that balancing the equities is the appropriate test.")

[45] See In re National Environmental Waste Corp., 129 F.3d 1052, 1055, 31 Bankr. Ct. Dec. (CRR) 876, Bankr. L. Rep. (CCH) P 77541 (9th Cir. 1997); Easley v. Pettibone Michigan Corp., 990 F.2d 905, 911, 28 Collier Bankr. Cas. 2d (MB) 1002 (6th Cir. 1993).

[46] In re Stockwell, 262 B.R. 275, 281, 37 Bankr. Ct. Dec. (CRR) 244 (Bankr. D. Vt. 2001).

[47] The Bankruptcy Court for the District of New Jersey appears to have had a practice that informally came to this result without requiring the filing of a motion to annul the stay. See In re Denby-Peterson, 576 B.R. 66, 81, 93 U.C.C. Rep. Serv. 2d 1367 (Bankr. D. N.J. 2017) ("For at least the last 20 years … the practice in this district has been that a creditor holding a car repossessed prepetition may request proof of insurance naming it as loss payee prior to turnover without violating the stay. But once proof of insurance has been produced, the creditor violates the stay by not returning the car."). The court questioned the basis for this practice and suggested that the minority interpretation of § 362(a)(3) is preferable, at least if there is a dispute about the debtor's ownership of the vehicle, but that for personal property free of liens, the creditor may violate the automatic stay by failing to return the property to the debtor on request. Id. at 82-83.

[48] One court has treated the lack of vehicle insurance as grounds for automatically annulling the automatic stay. The Bankruptcy Court for the Western District of Missouri has adopted a local rule, Rule 4070-1, prohibiting a debtor from operating an uninsured vehicle and giving the secured creditor, after notice to the debtor and an opportunity to obtain insurance, the right to repossess the vehicle without seeking relief from the automatic stay. When this rule was challenged, the court found that it was supported by annulment under § 362(d)(2). In re Suggs, 354 B.R. 903, 912 (Bankr. W.D. Mo. 2006), rev'd and remanded, 377 B.R. 198 (B.A.P. 8th Cir. 2007) (The Court … essentially annuls the automatic stay and retroactively validates the repossession. A rule authorizing the creditor's action and the entry of such an order is therefore not inconsistent with § 362.").

[49] See In re Hicks, 2011 WL 2414419 (Bankr. N.D. Ala. 2011).

[50] In re Garcia, 2017 WL 2951439 (Bankr. D. Kan. 2017).

[51] K.S.A. § 44-504.

98 F.3d 1147
United States Court of Appeals,
Ninth Circuit.

In re DEL MISSION LIMITED, Debtor.
STATE OF CALIFORNIA EMPLOYMENT DEVELOPMENT DEPARTMENT; State of California State Board of Equalization, Appellants,
v.
Harold S. TAXEL, Trustee for Del Mission Limited, Appellee.

No. 95-55658.
|
Argued and Submitted Aug. 9, 1996.
|
Decided Oct. 23, 1996.

Synopsis
State refused to approve sale of Chapter 7 debtor's liquor license until it paid all outstanding taxes and interest accrued thereon. Trustee paid taxes under protest and then sought repayment. The bankruptcy court found that state's action violated automatic stay and ordered state to repay taxes. State did not repay taxes in timely manner, and trustee sought to hold state in civil contempt of automatic stay and requested sanctions in form of fees and costs incurred in enforcing automatic stay on appeal. The bankruptcy court denied trustee's motion. On appeal, the Ninth Circuit Bankruptcy Appellate Panel reversed. State appealed. The Court of Appeals, Tashima, Circuit Judge, held that: (1) state violated automatic stay by knowingly retaining taxes that it had been ordered to repay debtor, and (2) statute authorizing bankruptcy court to award sanctions for ordinary civil contempt did not authorize discretionary award to trustee of fees and costs incurred in enforcing automatic stay against state in prior appellate proceedings.

Affirmed in part and reversed in part.

West Headnotes (16)

[1] **Bankruptcy** Taxation and licenses

Doctrine of merger did not immunize state from future violations of automatic stay, even though state had been found liable for past violations of stay, and thus, state's retention of taxes, which state had been ordered to repay after it was found that state violated stay by refusing to approve sale of Chapter 7 debtor's liquor license until it had paid outstanding taxes, could violate stay.

12 Cases that cite this headnote

[2] **Judgment** Nature and requisites of former recovery as bar in general

Doctrine of merger is subset of res judicata and precludes plaintiff from maintaining action on original claim after final judgment has been entered. Restatement (Second) of Judgments § 18 (1980).

8 Cases that cite this headnote

[3] **Bankruptcy**Taxation and licenses

State violated automatic stay by knowingly retaining taxes that it had been ordered to repay debtor. Bankr.Code, 11 U.S.C.A. § 362(a)(3).

8 Cases that cite this headnote

[4] **Bankruptcy**Proceedings, Acts, or Persons Affected

Knowing retention of estate property violates automatic stay. Bankr.Code, 11 U.S.C.A. § 362(a)(3).

31 Cases that cite this headnote

[5] **Bankruptcy**Collection and Recovery for Estate; Turnover

Duty of entity in possession of estate property to deliver such property to trustee is mandatory and arises upon filing of bankruptcy petition. Bankr.Code, 11 U.S.C.A. § 542(a).

25 Cases that cite this headnote

[6] **Bankruptcy**Proceedings, Acts, or Persons Affected

To effectuate purpose of automatic stay, which is to alleviate financial strains on debtor, onus to return estate property is placed upon possessor; it does not fall on debtor to pursue possessor.

24 Cases that cite this headnote

[7] **Bankruptcy**Carrying out provisions of Code

Bankruptcy Damages and attorney fees

Statute authorizing bankruptcy court to award sanctions for ordinary civil contempt did not authorize discretionary award to Chapter 7 trustee of fees and costs incurred in enforcing automatic stay against state in prior appellate proceedings. Bankr.Code, 11 U.S.C.A. § 105(a).

25 Cases that cite this headnote

[8] **Bankruptcy** Governmental claims; immunity waiver

State's waiver of sovereign immunity, by filing proof of claim against estate, is effective for claims arising out of same transaction or occurrence brought in response to claims filed by government. Bankr.Code, 11 U.S.C.A. § 106(a).

Cases that cite this headnote

[9] **Bankruptcy** Governmental claims; immunity waiver

By filing proof of claim for taxes that had accrued on liquor license of Chapter 7 debtor, state waived its sovereign immunity in case brought by trustee seeking sanctions against state for state's failure to repay taxes to trustee in violation of court order. Bankr. Code, 11 U.S.C.A. § 106(a).

4 Cases that cite this headnote

[10] **Bankruptcy** Damages and attorney fees

Trustee, as representative of bankruptcy estate, is not "individual" within meaning of statute allowing individual injured by willful violation of stay to recover actual damages and, therefore, cannot recover under statute. Bankr.Code, 11 U.S.C.A. § 362(h).

12 Cases that cite this headnote

[11] **Bankruptcy** Contempt
Bankruptcy Damages and attorney fees

Bankruptcy court may award damages to trustee for violation of automatic stay under its contempt power. Bankr.Code, 11 U.S.C.A. § 105(a)

28 Cases that cite this headnote

[12] **Bankruptcy** Carrying out provisions of Code
Bankruptcy Contempt

Statute authorizing bankruptcy court to award sanctions for ordinary civil contempt does not authorize award of appellate fees. Bankr.Code, 11 U.S.C.A. § 105(a).

8 Cases that cite this headnote

[13] **Bankruptcy** Frivolity or bad faith; sanctions

Only authority for awarding discretionary appellate fees in bankruptcy appeals is appellate rule governing damages and costs for frivolous appeals. F.R.A.P.Rule 38, 28 U.S.C.A.

13 Cases that cite this headnote

[14] **Bankruptcy** Carrying out provisions of Code
Bankruptcy Contempt
Bankruptcy Determination and Disposition; Additional Findings

Because awarding sanctions under statute authorizing bankruptcy court to award sanctions for ordinary civil contempt is discretionary function of bankruptcy court, appellate court may not impose contempt sanctions under statute based on its assumption of what bankruptcy court would do on remand. Bankr.Code, 11 U.S.C.A. § 105(a).

11 Cases that cite this headnote

[15] **Bankruptcy** Frivolity or bad faith; sanctions

Chapter 7 trustee, who failed to file separate motion for attorney fees incurred while defending state's appeal from Bankruptcy Appellate Panel's (BAP) judgment awarding trustee fees and costs trustee incurred in enforcing automatic stay against state in prior appellate proceedings, would not be allowed to file separate fee award motion; BAP's fee award was erroneous, and, thus, state's appeal was not frivolous and any separately-filed motion would be denied. F.R.A.P.Rule 38, 28 U.S.C.A.

7 Cases that cite this headnote

[16] **Federal Civil Procedure** Proceedings

Request made in appellate brief does not satisfy appellate rule governing damages and costs for frivolous appeals, which allows fee award only after separately filed motion or notice from court and reasonable opportunity to respond. F.R.A.P.Rule 38, 28 U.S.C.A.

11 Cases that cite this headnote

Attorneys and Law Firms

***1149** Richard W. Bakke, Deputy Attorney General, Los Angeles, CA, for appellants.

Jeffry A. Davis, Gray, Cary, Ware & Freidenrich, San Diego, CA, for appellee.

Appeal from the Ninth Circuit Bankruptcy Appellate Panel, Jones, Hagan and. BAP No. SC-94-1191-JhR.
Before: FLETCHER and TASHIMA, Circuit Judges, and RESTANI, Court of International Trade Judge.*

Opinion

TASHIMA, Circuit Judge:

This appeal presents two important issues. First, we consider whether failing to return bankruptcy estate property in a timely manner constitutes a violation of the automatic stay provision of 11 U.S.C. § 362(a)(3). We conclude that it does. Next, we resolve whether a bankruptcy court may award fees and costs incurred in prior appellate proceedings as a contempt sanction under 11 U.S.C. § 105(a). We conclude that it may not.

BACKGROUND

This is the second round of litigation between these parties. The first round arose when appellants California Employment Development Department and State Board of Equalization (collectively the "State") refused to approve the sale of Chapter 7 debtor Del Mission Limited's ("Del Mission") liquor license until it paid all outstanding taxes and interest accrued thereon. The trustee of Del Mission, appellee Harold S. Taxel ("Taxel"), paid the disputed taxes under protest, and then brought a proceeding in the bankruptcy court seeking repayment. The bankruptcy court found that the State's action violated the automatic stay provision of 11 U.S.C. § 362(a)(3), and ordered the State to pay Del Mission $15,604.[1] *Taxel v. California Employment Dev. Dep't (In re Del Mission Ltd.),* 116 B.R. 734 (Bankr.S.D.Cal.1990) ("*Del Mission I* "), *aff'd,* 130 B.R. 362, 1991 WL 169078 (9th Cir. BAP 1991) (TABLE in ***1150** Westlaw) ("*Del Mission II* "), *aff'd,* 998 F.2d 756 (9th Cir.1993) ("*Del Mission III* ").

The failure of the State to repay the disputed taxes in a timely manner is the subject of this second round of litigation. In spite of the bankruptcy court's order, the State did not repay the disputed taxes while the underlying case was being appealed. Following our decision in *Del Mission III,* Taxel filed a motion with the bankruptcy court seeking to hold the State in civil contempt of the automatic stay for failing to repay the disputed taxes in a timely manner.[2] As sanctions, Taxel requested attorney's fees and costs incurred in enforcing the automatic stay on appeal in *Del Mission II* and *Del Mission III.* The bankruptcy court denied the motion, concluding that the automatic stay violation merged into the previously awarded money judgment. As an alternative ground for its decision, the court also concluded that it had no legal authority to award fees incurred on prior appeals. The bankruptcy appellate panel ("BAP") reversed on both issues, and awarded Taxel the fees and costs he incurred in *Del Mission II* and *Del Mission III,* on the prior appeals.[3]

We have jurisdiction of this appeal under 28 U.S.C. § 158(d), and we affirm in part and reverse in part.

DISCUSSION

I. Continuing Violation of the Automatic Stay

The first issue we must decide is whether the State's failure to repay Del Mission in a timely manner constituted a continuing violation of 11 U.S.C. § 362(a)(3). "Because we are in as good a position as the BAP to examine the decision of the bankruptcy court, we independently review the bankruptcy court's ruling." *Havelock v. Taxel (In re Pace),* 67 F.3d 187, 191 (9th Cir.1995) (citation omitted). We review de novo whether the automatic stay provision of § 362(a) has been violated. *Chugach Timber Corp. v. Northern Stevedoring & Handling Corp. (In re Chugach Forest Prod., Inc.),* 23 F.3d 241, 244 (9th Cir.1994). We conclude that the State's retention of the disputed taxes did violate the automatic stay.

A. The Merger Doctrine

[1] [2] The doctrine of merger is a subset of res judicata and precludes a plaintiff from maintaining an action on the original claim after a final judgment has been entered. Restatement (Second) of Judgments § 18 (1980). The bankruptcy court reasoned that under this doctrine, the State's violation of the automatic stay ended with a final judgment in Taxel's favor. When judgment was entered, the violation of the stay ceased to exist and all remaining rights between the parties merged into the money judgment. It therefore rejected Taxel's motion for contempt, concluding that the State's retention of the disputed taxes could not, under the doctrine of merger, be a continuing violation of the automatic stay. We decline the State's invitation to adopt the reasoning of the bankruptcy court.

The bankruptcy court's analysis stretches the doctrine of merger beyond its intended limits. The doctrine of merger does not extinguish "advantages to which the plaintiff was entitled with respect to the original claim...." *Id.* at § 18, cmt. g. For example, "if a creditor has a lien upon property of the debtor and obtains a judgment against him, the creditor does not thereby lose the benefit of the lien." *Id.*

In the case at bench, the automatic stay, "an advantage[ ] to which the plaintiff was entitled with respect to the original claim," *id.,* remains effective until the bankruptcy estate terminates. *See* 11 U.S.C. § 362(c). Accordingly, until such time as the Del Mission estate terminates, the State is obligated to abide by the automatic stay. Thus, the doctrine of merger does not immunize the State from future violations of the stay, even though it has been found liable for past violations of the stay. *Cf., Harkins Amusement Enter. Inc. v. Harry Nace Co.,* 890 F.2d 181 (9th Cir.1989) (holding in an antitrust suit that res judicata

did not bar second lawsuit because the alleged violations occurred ***1151** during a different time period). The bankruptcy court therefore erred in concluding that, under the doctrine of merger, the State's retention of the disputed taxes could not be in violation of the stay.

B. Retention of the Disputed Taxes

[3] Given the continuing viability of the automatic stay, we must next consider whether the State did, in fact, violate the automatic stay by retaining the disputed taxes. 11 U.S.C. § 362(a)(3) specifically enjoins "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate...." In *Del Mission III,* we concluded that the State's efforts to collect the disputed taxes in the first instance did constitute a violation of the stay under subsection (3). 998 F.2d at 758.[4] Now, we take the analysis one step further, and determine whether the State's continued retention of the disputed taxes was an "act ... to exercise control over the property of the estate," in continuing violation of the automatic stay. 11 U.S.C. § 362(a)(3).

[4] The "exercise control" clause of § 362(a)(3) was added by the Bankruptcy Amendments and Federal Judgeship Act of 1984. Pub.L. No. 98-353, 1984 U.S.C.C.A.N. (98 Stat.) 371. Congress did not provide an explanation of that amendment. *In re Young,* 193 B.R. 620, 623 (Bankr.D.C.1996). The Ninth Circuit BAP has interpreted this amendment as broadening the scope of § 362(a)(3) to proscribe the mere knowing retention of estate property. *Abrams v. Southwest Leasing & Rental Inc. (In re Abrams),* 127 B.R. 239, 241-43 (9th Cir. BAP 1991) (failure to return repossessed car after receiving notice of Chapter 7 filing constituted a violation of the automatic stay). In dicta, this circuit has accepted that interpretation. *Chugach,* 23 F.3d at 246. We now adopt the reasoning of *Abrams* and *Chugach,* and hold that the knowing retention of estate property violates the automatic stay of § 362(a)(3).

[5] 11 U.S.C. § 542(a) provides that an entity in possession of estate property "shall" deliver such property to the trustee. This is a mandatory duty arising upon the filing of the bankruptcy petition. *Knaus v. Concordia Lumber Co. (In re Knaus),* 889 F.2d 773, 775 (8th Cir.1989). Thus, "[w]ithout doubt, 'a creditor's knowing retention of property of the estate constitutes a violation of' § 362(a)(3)." *Chugach* 23 F.3d at 246 (quoting *Abrams,* 127 B.R. at 242); *accord Knaus,* 889 F.2d at 775 ("The failure to [turn over], regardless of whether the original seizure was lawful, constitutes a prohibited attempt to 'exercise control over the property of the estate' in violation of the automatic stay."); *Carlsen v. IRS (In re Carlsen),* 63 B.R. 706, 711 (Bankr.C.D.Cal.1986) (failure of IRS to return funds received pursuant to a levy after receiving notice violated automatic stay).

[6] These cases emphasize the underlying purpose of the automatic stay, which is to alleviate the financial strains on the debtor. *See, e.g., Knaus,* 889 F.2d at 775; *see also Utah State Credit Union v. Skinner (In re Skinner),* 90 B.R. 470 (D.Utah 1988), *aff'd,* 917 F.2d 444 (10th Cir.1990). To effectuate the purpose of the automatic stay, the onus to return estate property is placed upon the possessor; it does not fall on the debtor to pursue the possessor. *Abrams,* 127 B.R. at 243.

> [I]f persons who could make no substantial adverse claim to a debtor's property in their possession could, without cost to themselves, compel the debtor or his trustee to bring suit as a prerequisite to returning the property, the powers of a bankruptcy court and its officers to collect the estate for the benefit of creditors would be vastly reduced.

Knaus, 889 F.2d at 775. Moreover, "the case law and the legislative history of § 362 indicate that Congress did not intend to place the burden on the bankruptcy estate to absorb the expense of potentially multiple turnover actions, at least not without providing a means to recover damages sustained as a ***1152** consequence thereof." *Abrams,* 127 B.R. at 243.

Under this line of authority, we conclude that the State's knowing retention of the disputed taxes violated the automatic stay. As this case shows, the potential for multiple actions to obtain what is rightfully due to a bankruptcy estate is a very real concern. The State contends that it did not repay Del Mission in a timely manner because Taxel did not make any specific

demand on it. As noted by the BAP, "[t]his argument is frivolous." BAP Dec. at 7. In *Del Mission I,* the bankruptcy court specifically held that Del Mission was entitled to a refund of the disputed taxes. 116 B.R. at 739. Moreover, the State cites no support for its contention that no obligation to repay arose until it received a specific request from the trustee. That contention is in direct conflict with *Abrams* and *Chugach.*

In summary, both the case law and policy considerations compel the conclusion that the State violated the automatic stay by knowingly retaining the disputed taxes, following the bankruptcy court's order to repay Del Mission.

II. The Scope of a Bankruptcy Court's Contempt Power under 11 U.S.C. § 105(a)[5]

[7] [8] [9] Although the State violated the automatic stay, whether that violation authorized the BAP to award Taxel previously incurred appellate fees presents another question entirely. A bankruptcy court's award of attorney's fees is reviewed for an abuse of discretion or an erroneous application of the law. *Feder v. Lazar (In re Lazar),* 83 F.3d 306, 308 (9th Cir.1996). In the absence of direct authority, we apply this same standard of review to the BAP's award of fees. Upon review, we conclude that the BAP's award of fees was erroneous because § 105(a) does not authorize an award of previously incurred appellate fees as a sanction.[6]

[10] Typically, damages for a violation of the automatic stay are recovered under 11 U.S.C. § 362(h). This section mandates the award of actual damages to "[a]n *individual* injured by any willful violation of a stay provided by this section." *Id.* (emphasis added). A trustee, as the representative of a legal entity (the bankruptcy estate), is not an "individual" within the meaning of § 362(h), and therefore cannot recover under this statute. *Pace,* 67 F.3d at 192.

[11] Notwithstanding § 362(h)'s inapplicability, a bankruptcy court may award damages to a trustee for a violation of the automatic stay under its contempt power pursuant to 11 U.S.C. § 105(a). *Pace,* 67 F.3d at 193. Section 105(a) provides that a bankruptcy court "may issue any order ... that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). This provision is broad enough to provide relief to those entities that are injured by willful violations of the automatic stay, but cannot recover under § 362(h). *Pace,* 67 F.3d at 193; *United States v. Arkison (In re Cascade Rds., Inc.),* 34 F.3d 756, 767 (9th Cir.1994). The only meaningful difference between awarding damages under ***1153** § 362(h), as opposed to § 105(a), is that relief under § 362(h) is mandatory, while relief under § 105(a) is discretionary. *Pace,* 67 F.3d at 193-94. However, this does not answer the question of whether § 105(a) authorizes a court to award previously incurred appellate fees. We now turn to that issue of first impression.

[12] The bankruptcy court concluded that it could not award fees for appellate representation under *Vasseli v. Wells Fargo Bank (In re Vasseli),* 5 F.3d 351 (9th Cir.1993), which holds that a bankruptcy court has no authority to award appellate attorney's fees under 11 U.S.C. § 523(d). The BAP, however, concluded that *Vasseli* did not foreclose an award of previously incurred appellate fees under a bankruptcy court's contempt power. We agree with the bankruptcy court and conclude, under the reasoning of *Vasseli,* that § 105(a) does not authorize an award of appellate fees.

In *Vasseli,* Chapter 7 debtors successfully defended a motion brought by a creditor under 11 U.S.C. § 523(a), to determine the dischargeability of a consumer debt. 5 F.3d at 352. The bankruptcy court awarded attorney's fees as provided under § 523(d). *Id.* The creditor's appeal to the district court was dismissed as untimely. *Id.* at 353. The debtors then returned to the bankruptcy court and, invoking § 523(d), requested additional attorney's fees incurred in the appeal to the district court. *Id.*

Relying on Fed.R.App.P. 38, we held that a bankruptcy court does not have the authority to award attorney's fees incurred in response to a frivolous appeal under § 523(d). *Id. Vasseli* further held that Rule 38 is the only authority for awarding appellate fees incurred as a result of a frivolous appeal. *Id.* We agreed with the BAP's holding that "Rule 38 empowers *only appellate courts, not bankruptcy courts* to award damages, attorney's fees, and other expenses incurred by an appellee in response to a frivolous appeal." *Id.* (emphasis added). Moreover, *Vasseli* held that an appellate court does not have the authority to delegate this power to a bankruptcy court. *Id.* Thus, *Vasseli* concluded that the debtors "should have applied to the district court, not the bankruptcy court, for costs incurred on their appeal pursuant to Rule 38." *Id.* at 354.

In the instant case, the BAP distinguished *Vasseli* by concluding that the plain language of § 523(d) precludes an award of appellate fees. § 523(d) provides:

> [i]f a creditor requests a determination of dischargeability of a consumer debt ..., and such debt is discharged, the court shall grant judgment in favor of the debtor for the costs of, and a reasonable attorney's fee for, *the proceeding* if the court finds that the position of the creditor was not substantially justified....

11 U.S.C. § 523(d) (emphasis added). The BAP found the emphasized phrase to be "limiting language" precluding an award of appellate fees. BAP Dec. at 11. The BAP then noted that it was not constrained by such limiting language under the stay violation provisions, and therefore was not precluded from awarding previously incurred appellate fees.

While the BAP's construction of § 523(d)'s "limiting language" may be correct-that is, the language itself may preclude an award of appellate fees-that was not the basis relied upon by *Vasseli* to conclude that a bankruptcy court lacked the authority to award appellate fees. As mentioned above, *Vasseli* relied entirely upon Rule 38, and construed Rule 38 as the only authority that provides for appellate fees for frivolous appeals. *See Vasseli,* 5 F.3d at 354. Accordingly, while the BAP's attempt to distinguish *Vasseli* may have some surface appeal, it nevertheless must fail because there is no basis for the BAP's conclusion that *Vasseli* 's holding is based on the "limiting language" of § 523(d).

We thus conclude that *Vasseli* is indistinguishable in principle from the instant case, and controls its outcome. *Vasseli* rejected the idea that a court's express discretionary authority to award fees at the trial level implied an authority to award fees at the appellate level. *See Vasseli,* 5 F.3d at 353 (refusing to "read into" § 523(d) the authority to award appellate fees). Here, § 105(a) has been construed as a vehicle to award discretionary fees at the trial court level. *Pace,* 67 F.3d at 193. *Vasseli* instructs that ***1154** we should not imply from that limited grant of authority a similar authority to award fees at the appellate level.

[13] [14] Moreover, because an award under § 105(a) is discretionary, its use as a device to award previously incurred appellate fees would overlap with Rule 38. Under either authority, a court would be required to consider the merits of the arguments advanced and the manner in which the parties acted in determining whether to award fees. Given that Rule 38 already provides for a discretionary award of fees in frivolous appeals, it would be superfluous to treat § 105(a) as another vehicle to award appellate fees. In accord with *Vasseli,* we therefore hold that the only authority for awarding discretionary appellate fees in bankruptcy appeals is Rule 38.[7] Accordingly, the bankruptcy court did not err in refusing to award Taxel previously incurred appellate fees.[8]

We therefore reverse the BAP's award to Taxel of previously incurred appellate fees.[9]

III. Attorney's Fees for this Appeal

[15] In his responding brief, Taxel includes a motion for attorney's fees incurred while defending this current appeal, under both § 105(a) and Rule 38. As we have concluded § 105(a) does not authorize appellate fees, we consider only the request made under Rule 38.

[16] The 1994 Amendment to Rule 38 permits an award of fees only "after a separately filed motion or notice from the court and reasonable opportunity to respond[.]" Fed.R.App.P. 38 (1994). Taxel has not filed such a separate motion. A request made in an appellate brief does not satisfy Rule 38. *See Gabor v. Frazer,* 78 F.3d 459, 459-60 (9th Cir.1996) (denying Rule 38 motion without prejudice, and allowing the requesting party to file a separate fee motion).

In this case, we do not deem it appropriate to deny the motion without prejudice and allow Taxel to file a separate motion.

Given that the BAP's fee award was erroneous, the State's appeal was clearly not frivolous. Accordingly, because any separately-filed Rule 38 motion would be denied, permitting Taxel to file such a motion would be futile.

CONCLUSION

The BAP correctly concluded that the State's retention of the disputed taxes violated the automatic stay provisions of 11 U.S.C. § 362(a)(3). However, it erred in concluding that 11 U.S.C. § 105(a) authorizes an award of previously incurred appellate fees. The BAP's award of such fees to Taxel is therefore reversed.

AFFIRMED in part and REVERSED in part. Each party shall bear its or his own costs on appeal. Taxel's motion for fees on appeal is denied.

All Citations

98 F.3d 1147, 65 USLW 2290, 36 Collier Bankr.Cas.2d 1658, 36 Fed.R.Serv.3d 512, 29 Bankr.Ct.Dec. 1155, Bankr. L. Rep. P 77,176, 96 Cal. Daily Op. Serv. 7789, 96 Daily Journal D.A.R. 12,877

Footnotes

* The Honorable Jane A. Restani, Judge of the United States Court of International Trade, sitting by designation.

1 In a separate order, the bankruptcy court also awarded sanctions against the State equal to the amount of Del Mission's attorney's fees incurred in the bankruptcy court. That order is not at issue in this appeal.

2 Soon after Taxel filed the motion for contempt, the State repaid the disputed taxes.

3 Hereinafter these fees and costs shall be referred to as "previously incurred appellate fees."

4 *Del Mission III* also held that the State's actions violated subsection 6 of § 362(a). 998 F.2d at 758. Subsection 6 enjoins "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title[.]" 11 U.S.C. § 362(a)(6).

5 Although the BAP did not cite to § 105(a), it is the authority that authorizes a bankruptcy court to award sanctions for ordinary civil contempt. *Pace,* 67 F.3d at 193.

6 Sanctions cannot be issued against the State unless it has waived sovereign immunity. At the time the State filed a claim for the underlying disputed taxes, a governmental unit waived its sovereign immunity by filing a proof of claim against the bankruptcy estate. 11 U.S.C. § 106(a) (1993). This waiver is effective for claims arising out of the same transaction or occurrence brought in response to the claims filed by the government. *Id.* Accordingly, the state has waived its sovereign immunity in the instant case.
We note that the 1994 Amendments to 11 U.S.C. § 106(a) specifically abrogate sovereign immunity for cases arising under §§ 105 and 362. *See* Bankruptcy Reform Act of 1994, Pub.L. No. 103-394, § 113, 1994 U.S.C.C.A.N. (108 Stat.) 4106, 4117-18. We further note that there are potential constitutional problems with these amendments. *See Ohio Agric. Commodity Depositors Fund v. Mahern,* 517 U.S. 1130, 116 S.Ct. 1411, 134 L.Ed.2d 537 (1996) (summarily vacating and remanding Seventh Circuit decision upholding constitutionality of the 1994 Amendments in light of *Seminole Tribe v. Florida,* 517 U.S. 44, 116 S.Ct. 1114, 134 L.Ed.2d 252 (1996)). In the case at bench, we need not consider the constitutionality of the 1994 Amendments because it is clear that the State waived sovereign immunity under pre-amendment law.

7 Our holding is limited to awards of discretionary appellate fees in bankruptcy proceedings. We do not consider whether some bankruptcy statutes, such as § 362(h), may provide for a mandatory award of appellate fees.

[8] Moreover, we note that even if § 105(a) did authorize an award of previously incurred appellate fees, we would still be compelled to vacate the BAP's award. Because awarding sanctions under § 105(a) is a discretionary function of the bankruptcy court, an appellate court may not impose contempt sanctions under § 105(a) based on its assumption of what a bankruptcy court would do on remand. *See Pace,* 67 F.3d at 193-94 (although bankruptcy court expressed great displeasure with stay violator, BAP's imposition of sanctions was vacated so that the bankruptcy court could determine what sanctions, if any, to impose); *see also Cascade Rds.,* 34 F.3d 756, 766-67 (9th Cir.1994) (remanding so bankruptcy court could decide whether to award fees in its discretion); *Johnston Envtl. Corp. v. Knight, (In re Goodman),* 991 F.2d 613, 620 (9th Cir.1993) (same).

[9] Because the award must be vacated, it is unnecessary for us to address the State's argument that the amount of the award was excessive.

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719 F.3d 72
United States Court of Appeals,
Second Circuit.

In re Christopher WEBER, Debtor.
Christopher Weber, Plaintiff–Appellee,
v.
SEFCU, Defendant–Appellant,
Andrea E. Celli, Chapter 13 Trustee, Trustee.

Docket No. 12–1632–bk.
|
Argued: Dec. 4, 2012.
|
Decided: May 8, 2013.

Synopsis

Background: Upon finding that secured creditor violated the Bankruptcy Code's automatic stay provision, the United States District Court for the Northern District of New York, Suddaby, J., 477 B.R. 308, reversed an order of the United States Bankruptcy Court for the Northern District of New York, Littlefield, J., and remanded to the Bankruptcy Court for a determination regarding sanctions. Creditor appealed.

Holdings: The Court of Appeals, Susan L. Carney, Circuit Judge, held that:

[1] creditor's refusal to return the vehicle to debtor promptly upon learning of his Chapter 13 bankruptcy filing constituted an unlawful "exercise [of] control" over the "property" of his estate in violation of the automatic stay, and

[2] because secured creditor intended to retain debtor's repossessed vehicle upon learning of debtor's bankruptcy filing, creditor "willfully" violated automatic stay.

Affirmed and remanded.

West Headnotes (6)

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

Court of Appeals conducts a plenary review of a decision of a district court functioning in its capacity as an appellate court in a bankruptcy case, and thus, reviews de novo the bankruptcy court's legal conclusions.

6 Cases that cite this headnote

[2] **Bankruptcy** Repossession

Although secured creditor's repossession of debtor's vehicle before debtor filed his Chapter 13 petition lawfully overrode debtor's immediate possessory rights, the parties agreed that New York law afforded debtor at least a continuing equitable interest in the vehicle; therefore, creditor's refusal to return the vehicle to debtor promptly upon learning of his Chapter 13 bankruptcy filing constituted an unlawful "exercise [of] control" over the "property" of his estate in violation of the automatic stay. 11 U.S.C.A. §§ 362, 541, 542.

12 Cases that cite this headnote

[3] **Bankruptcy** Enforcement of Injunction or Stay

Bankruptcy Code's automatic stay provision requires a creditor in possession of property seized as security, but subject to a state-law-based residual equitable interest in the debtor, to deliver that property to the trustee or debtor-in-possession promptly after the debtor has filed a petition in bankruptcy under Chapter 13. 11 U.S.C.A. § 362.

9 Cases that cite this headnote

[4] **Bankruptcy** Repossession

Secured creditor's belief that Chapter 13 debtor had not provided "adequate protection" for creditor's security interest in debtor's vehicle did not excuse creditor's violation of automatic stay by failing to surrender repossessed vehicle promptly upon learning of debtor's Chapter 13 bankruptcy filing. 11 U.S.C.A. §§ 362, 542.

7 Cases that cite this headnote

[5] **Bankruptcy** Enforcement of Injunction or Stay

A creditor "willfully" violates Bankruptcy Code's automatic stay provision when it knows of the filing of the petition and hence of the automatic stay, and has the general intent simply to perform the act found to violate the stay; no specific intent to violate the stay is necessary. 11 U.S.C.A. § 362.

7 Cases that cite this headnote

[6] **Bankruptcy** Damages and attorney fees

Because secured creditor intended to retain debtor's repossessed vehicle upon learning of debtor's Chapter 13 bankruptcy filing, creditor "willfully" violated automatic stay provision, and was thus liable for damages, costs, and attorney fees. 11 U.S.C.A. § 362(h, k).

10 Cases that cite this headnote

Attorneys and Law Firms

***73** Gary A. Lefkowitz (William B. Schiller, on the brief), Schiller & Knapp, LLP, Latham, NY, for Defendant–Appellant.

Richard Croak, Albany, NY, for Plaintiff–Appellee.

Tara Twomey (Ray DiGuiseppe, on the brief), National Consumer Bankruptcy Rights Center, San Jose, CA, for amicus curiae National Association of Consumer Bankruptcy Attorneys, in support of Plaintiff–Appellee.

Before: CABRANES, RAGGI, and CARNEY, Circuit Judges.

Opinion

SUSAN L. CARNEY, Circuit Judge:

Defendant SEFCU, a lender, appeals from a judgment of the United States District Court for the Northern District of New York (Suddaby, *J.*) reversing an order of the United States Bankruptcy Court for the Northern District of New York (Littlefield, *J.*) and remanding the case to the Bankruptcy Court for further proceedings. The District Court concluded that SEFCU violated the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 362, when, after lawfully repossessing a vehicle belonging to the debtor, plaintiff Christopher Weber, it failed to deliver the vehicle to him notwithstanding its knowledge of the debtor's pending petition under Chapter 13 of the Bankruptcy Code. The District Court affirmed, holding that, by declining to surrender the vehicle absent a turnover order and protection SEFCU considered adequate, the lender wrongfully "exercised control" over the vehicle in contravention of section 362 and ***74** was liable for Weber's related damages, attorneys' fees, and costs.

On appeal to our Court, SEFCU challenges the District Court's interpretation of section 362 and other relevant provisions of the Bankruptcy Code, and argues that, under the authority of *Manufacturers & Traders Trust Co. v. Alberto (In re Alberto),* 271 B.R. 223 (N.D.N.Y.2001), it was entitled to retain the vehicle notwithstanding the pending bankruptcy proceedings. For the reasons set forth below, we AFFIRM the judgment of the District Court and REMAND the cause to the district court for a determination of the amount of damages, costs, and attorneys' fees that SEFCU owes Weber under section 362(k), and any other proceedings consistent with this opinion.

BACKGROUND

The relevant facts are undisputed.[1]

In August 2006, Weber and SEFCU (identified in Bankruptcy Court pleadings as the "State Employees Federal Credit Union")[2] entered into a loan agreement pursuant to which SEFCU obtained a security interest in Weber's vehicle, a pickup truck. The loan agreement entitled SEFCU to repossess Weber's vehicle upon default.

In 2009, SEFCU became entitled to proceed against Weber. As a result, on January 10, 2010, SEFCU took possession of Weber's vehicle pursuant to the loan agreement, and, by notices dated January 10 and 11, 2010, advised him of his right under New York law to redeem the vehicle upon payment of amounts due and certain costs. Four days after the seizure, on January 14, Weber filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code, 11 U.S.C. §§ 109(e), 1301–08, 1321–30, in the United States Bankruptcy Court for the Northern District of New York. Weber's attorney concurrently gave SEFCU written notice of Weber's bankruptcy filing, and, invoking the stay imposed by Bankruptcy Code section 362, 11 U.S.C. § 362(a), requested the vehicle's return.

One week later, SEFCU still had the vehicle, and accordingly, on January 22, Weber filed an adversary proceeding against SEFCU seeking its return so that, as later explained by his counsel to the Bankruptcy Court, he could "continue his construction business" during the pendency of his petition. On March 1, with the vehicle still in SEFCU's possession, the Bankruptcy Court entered an order requiring SEFCU to show cause why it should not return the vehicle and why the court should not grant Weber an award of damages for SEFCU's violation of section 362 and for other relief. On March 4, the court heard argument on the order to show cause, and, although the record does not reflect entry of a related order at that time, SEFCU is reported to have returned the vehicle to Weber the following day.

The proceedings in the Bankruptcy Court continued, as Weber sought damages for his inability to use the vehicle between January 14 and March 5, attorneys' fees, and sanctions. In November 2010, SEFCU moved for summary judgment, ***75** putting to the Bankruptcy Court the question of law whether SEFCU's failure to release the vehicle promptly after the petition was filed constituted a "willful" violation of the automatic stay under subsections (a) and (k)(1) of section 362 (providing for recovery of damages, costs, and attorneys' fees for "any willful violation of a stay"). SEFCU maintained that there was no violation, and that an earlier district court decision in other proceedings, *Alberto,* 271 B.R. 223 (N.D.N.Y.2001), gave it a reasonable basis for declining to release the vehicle absent a court order issued pursuant to Bankruptcy Code section 542, 11 U.S.C. § 542 (relating to "Turnover of property to the estate"). Weber, for his part, argued that *Alberto* was wrongly decided, and that section 362 required SEFCU to release the vehicle promptly after the petition was filed. The Bankruptcy Court, in a brief Order, granted summary judgment for SEFCU.

Weber appealed to the District Court. Relying primarily on the Supreme Court's decision in *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983), and rejecting the reasoning of the *Alberto* court, the district court concluded that SEFCU was bound to release the vehicle to Weber, the debtor-in-possession, upon learning of Weber's pending Chapter 13 proceedings. The district court further determined that, having failed to do so, SEFCU violated section 362. Because it knew of the petition and retained the vehicle, SEFCU's violation was willful, making it liable for damages and attorneys' fees. *Weber v. SEFCU,* 477 B.R. 308, 311 (N.D.N.Y.2012). SEFCU timely appealed.

DISCUSSION

[1] We conduct a "plenary review" of a decision of "a district court functioning in its capacity as an appellate court in a bankruptcy case." *Mazzeo v. United States (In re Mazzeo),* 131 F.3d 295, 301 (2d Cir.1997). Thus, we review *de novo* the bankruptcy court's legal conclusions. *Resolution Trust Corp. v. Best Prods. Co. (In re Best Prods. Co.),* 68 F.3d 26, 29 (2d

Cir.1995). As noted above, the relevant facts are not contested; we have no occasion to subject them to further review.

Under Bankruptcy Code section 541, governing "Property of the estate," the act of filing a petition for bankruptcy creates an estate comprised of (as relevant here) "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." 11 U.S.C. § 541(a)(1). Section 541 gathers into the estate all such interests in property, "wherever located and by whomever held." *Id.* § 541(a).

To assemble the bankruptcy estate, section 542 of the Code requires that, during bankruptcy proceedings, an entity "in possession, custody, or control" of certain property in the estate "*shall deliver* " that property to the trustee, "unless such property is of inconsequential value or benefit to the estate." 11 U.S.C. § 542(a) (emphasis added). The property subject to this delivery obligation is "property that the trustee may use, sell, or lease under section 363," which grants broad powers over the estate's property to the trustee.[3] *Id.* ***76** In a Chapter 13 bankruptcy, the debtor "remain [s] in possession of all property of the estate"—acting in effect as trustee under section 542(a)—unless the debtor's reorganization plan provides otherwise. 11 U.S.C. § 1306(b).[4] The delivery obligation of section 542(a) thus contemplates the debtor-in-possession as the recipient of the property of the estate.

While bankruptcy proceedings are pending, the automatic stay provisions of section 362 work with sections 541 and 542 to shelter the debtor's estate from action by creditors, enabling the debtor to get the relief and fresh start that are among the goals of the bankruptcy regime.[5] Thus, under section 362, filing a bankruptcy petition automatically effects a stay of "any act to obtain possession of property of the estate ... or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Those who violate section 362 are liable for related damages and costs: under section 362(k), a debtor "injured by any willful violation of a stay provided by [section 362] *shall recover* actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." *Id.* § 362(k)(1) (emphasis added).

We first consider whether SEFCU's refusal to return the vehicle to Weber promptly upon learning of his Chapter 13 bankruptcy filing constituted an unlawful "exercise [of] control" over the "property" of his estate, in violation of the automatic stay. We then examine whether SEFCU may be excused from promptly surrendering the vehicle because Weber had not provided "adequate protection" for SEFCU's security interest in the vehicle. Finally, because we conclude that SEFCU's actions did violate section 362, we then turn to the question whether, in light of its reliance on *Alberto,* SEFCU's violation was nonetheless "willful" under section 362(k), making it liable for Weber's actual damages, costs, and attorneys' fees under that section.

I.

[2] As observed above, section 541(a) provides that a bankruptcy estate is comprised of "all legal or equitable interests in property as of the commencement of the case."[6] Although SEFCU's repossession ***77** of the vehicle before Weber filed his petition lawfully overrode Weber's immediate possessory rights, the parties agree that New York law afforded Weber at least a continuing equitable interest in the vehicle. *See Wornick v. Gaffney,* 544 F.3d 486, 490 (2d Cir.2008) ("Whether the debtor has a legal or equitable interest in property such that it becomes property of the estate under section 541 is determined by applicable state law." (internal quotation marks omitted)). That interest arose from Weber's right pursuant to the state Uniform Commercial Code to redeem the vehicle before sale. *See* N.Y. U.C.C. § 9–623.[7] It was this right that SEFCU acknowledged and identified for Weber in its notice to him dated January 11. Weber's equitable interest thus constituted "property" of the bankruptcy estate under section 541. Neither party seriously challenges the scope of that definition.

Rather, Weber and SEFCU dispute whether, by failing to surrender the vehicle immediately upon receiving notice of the petition's filing, SEFCU "exercise[d] control" over Weber's equitable interest in the vehicle and thereby violated the stay imposed by section 362. The Supreme Court's decision in *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 103 S.Ct. 2309,

76 L.Ed.2d 515 (1983), provides important guidance for our resolution of this issue.

The dispute in *Whiting Pools* arose when, to satisfy a tax lien, the IRS seized all of the tangible personal property of the corporation. One day after the seizure, the corporation filed for bankruptcy. The IRS moved for relief from the automatic stay, wishing to be free to sell the personal property that it had seized in satisfaction of the tax debts owed. The debtor corporation counterclaimed and, in the bankruptcy court, successfully sought an order under section 542 that required the IRS to return the property to the estate. *Id.* at 199–201, 103 S.Ct. 2309.

The Supreme Court affirmed the bankruptcy court's turnover order. Characterizing the IRS's interest in the seized property as "its lien"—not ownership—and analogizing the Service's right to effect a seizure to the remedies available to private secured creditors, the Court described the seizure as "not determin[ing] the Service's rights to the seized property, but merely bring[ing] the property into the Service's legal custody." *Id.* at 210–11, 103 S.Ct. 2309. It explained that "[i]n effect, § 542(a) grants to the estate a possessory interest in certain property of the debtor that was not held by the debtor at the commencement of reorganization proceedings," *id.* at 207, 103 S.Ct. 2309, and "requires an entity ... holding any property of the debtor that the trustee can use ***78** under § 363 to turn that property over to the trustee." *Id.* at 205–06, 103 S.Ct. 2309.

The Court underscored the Congressional intent, in shaping the definition of "property" set forth in section 541(a), to include "a broad range" of property in the estate, and indeed, to capture "any property made available to the estate by other provisions of the Bankruptcy Code." *Id.* at 204–05, 103 S.Ct. 2309. Section 542(a) is such a provision. It requires delivery to the trustee of "any property of the debtor that the trustee can use under § 363," including property repossessed by a secured creditor. *Id.* at 205–06, 103 S.Ct. 2309. "Any other interpretation of § 542(a)," the Court declared, "would deprive the bankruptcy estate of the assets and property essential to its rehabilitation effort and thereby would frustrate the congressional purpose behind the reorganization provisions." *Id.* at 208, 103 S.Ct. 2309.

For these reasons, the Court restricted the IRS—like any other creditor seizing property in which it held a security interest—to seeking protection of its interests "according to the congressionally established bankruptcy procedures, rather than by withholding the seized property from the debtor's efforts to reorganize." *Id.* at 212, 103 S.Ct. 2309.

Similarly, here, SEFCU seized Weber's vehicle before Weber filed for bankruptcy, but under New York law, Weber retained at least an equitable interest in the property notwithstanding its repossession. SEFCU did not automatically obtain an ownership interest in the vehicle: its rights to seize and sell were subject to U.C.C. provisions of state law, including certain continuing rights held by Weber, and also subject to the rights and remedies established by the Bankruptcy Code. *Whiting Pools* teaches that, upon Weber's filing of his bankruptcy petition, Weber's equitable interest under state law gave the bankruptcy estate a possessory right in the secured property, as property that the trustee could use under section 363. Under section 542, that right took precedence over the state law possessory right of SEFCU. *See id.* at 207, 103 S.Ct. 2309.

It is true that *Whiting Pools* involved a Chapter 11 corporate reorganization, and that the Supreme Court expressly reserved judgment as to whether its analysis would also apply to Chapter 13 personal reorganizations like Weber's. 462 U.S. at 208 n. 17, 103 S.Ct. 2309. But, like other courts to have addressed the issue, we observe that the language of sections 541, 542, and 362 applies to the "estate," not just the "reorganization estate." *See Austein v. Schwartz (In re Gerwer),* 898 F.2d 730, 734 (9th Cir.1990) (cited in *In re Velichko,* 473 B.R. 64, 67 (Bankr.S.D.N.Y.2012)). We see no reason—and the parties have presented none—to restrict application of the reasoning of the *Whiting Pools* Court to corporate reorganizations: the same concerns apply fully in the Chapter 13 context as well. *See, e.g., Thompson v. General Motors Acceptance Corp.,* 566 F.3d 699, 705–06 (7th Cir.2009) (applying *Whiting Pools* in Chapter 13 setting and observing that the "purpose of reorganization bankruptcy, *be it corporate or personal,* is to allow the debtor to regain his financial foothold and repay his creditors") (emphasis added). As noted above, Weber required his vehicle to conduct his construction business; Whiting Pools required its equipment and other personal property to conduct its business. In each case, the reorganization's chances for success would seem markedly improved if operations could be maintained during the pendency of the petition and formulation of the plan.

Whiting Pools does not resolve, however, whether by demanding a turnover order of the bankruptcy court or "adequate ***79** protection" as a condition of its relinquishment, SEFCU "exercise[d] control" over the vehicle in contravention of the stay. In

Whiting Pools, the IRS—unlike SEFCU—moved for relief from the stay, and did not simply wait for the debtor to initiate an adversary proceeding or seek a turnover order under section 542. *Id.* at 201, 103 S.Ct. 2309. Thus, the Court there held only that the bankruptcy court properly ordered the IRS to return the seized property to the estate under section 542. *Id.* at 212, 103 S.Ct. 2309.

The district court's decision in *Alberto,* relied upon by SEFCU here, directly addressed the question left unanswered by *Whiting Pools.* The *Alberto* court concluded that a secured creditor did *not* violate the automatic stay when, after learning of the debtor's bankruptcy, it failed immediately to return a debtor's repossessed vehicle. 271 B.R. at 228. Rather, the court held that before such a secured creditor was obligated to surrender the collateral to the estate, the debtor must "take[ ] an affirmative step," such as obtaining a turnover order under section 542. *Id.* at 227. Because (as it found) a repossessed vehicle was not part of the debtor's estate until such an action had occurred, the court reasoned that a creditor that had taken possession of its security did not "exercise control" over "property" of the estate by declining to surrender the possessory interest to the estate. *Id.* at 228. Since the debtor no longer had a possessory interest, the court concluded, the creditor "did not 'act to obtain possession ... or to exercise control' of the vehicle in violation of the stay, since it already lawfully possessed and controlled the vehicle when the stay went into effect." *Id.* at 226 (alteration in original) (quoting 11 U.S.C. § 362(a)(3)).

We find the *Alberto* court's reasoning unpersuasive. Section 541 expressly provides that the "property" of Weber's estate includes equitable interests, and Weber's right to redeem and other rights catalogued above, together with his lingering claim to ownership of title, comprise such an interest. That SEFCU had already effected a repossession does not alter the conclusion that the equitable interest is property of the estate: section 541 provides further that the estate is comprised of property "wherever located and by whomever held." 11 U.S.C. § 541(a). Nor was Weber obligated to initiate an additional proceeding. Section 542 requires that any entity in possession of property of the estate deliver it to the trustees, without condition or any further action: the provision is "self-executing." *Collier on Bankruptcy* § 542.02 (16th ed. 2012) ("By its express terms, [section 542] is self-executing, and does not require that the trustee take any action or commence a proceeding or obtain a court order to compel the turnover."). And *Whiting Pools* teaches that the filing of a petition will generally transform a debtor's equitable interest into a bankruptcy estate's possessory right in the vehicle.

[3] As for whether SEFCU's refusal to return the vehicle to the estate violated the stay, section 362 forbids any act to "obtain possession" or "exercise control" over the property of the estate. We need consult only an ordinary dictionary to confirm that a typical definition of "control" is: "To exercise authority over; direct; command." Webster's New World College Dictionary (4th ed. 2002). In light of that definition, we see no way to avoid the conclusion that, by keeping custody of the vehicle and refusing Weber access to or use of it, SEFCU was "exercising control" over the object in which the estate's equitable interest lay, and its retention of the vehicle violated the stay.

***80** The Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "1984 Amendments") confirms our conclusion. The 1984 Amendments, passed after the *Whiting Pools* decision in 1983, broadened the already sweeping provisions of the automatic stay even further to prohibit expressly not only "acts to obtain possession" of property of the estate, but also "any act ... to exercise control over the property of the estate." Pub. L. No. 98–353, 98 Stat. 333, 371. This significant textual enlargement is consonant with our understanding and the Supreme Court's interpretation that Congress intended to prevent creditors from retaining property of the debtor in derogation of the bankruptcy procedure and the broad goals of debtor protection discussed above, without regard to what party was in possession of the property in question when the petition was filed. As the Seventh Circuit has pointed out, "Although Congress did not provide an explanation of that amendment, the mere fact that Congress expanded the provision to prohibit conduct above and beyond obtaining possession of an asset suggests that it intended to include conduct by creditors who seized an asset pre-petition." *Thompson,* 566 F.3d at 702 (citation omitted).

The rule adopted by the *Alberto* court and urged on us by SEFCU—that some additional act by the debtor is required before the creditor is obligated to surrender the property—would, in contrast, place on the debtor or trustee the burden of undertaking a series of adversary proceedings to pull together the bankruptcy estate, and thereby increase the costs of administering the estate and decrease the assets available to effect a successful reorganization. In our view, the plain language of section 542 (directing that those in custody of assets of the estate "shall deliver" them to the trustee); the approach of the

Whiting Pools Court to equitable interests and bankruptcy estates; and the broad language of the 1984 Amendments enlarging the scope of the automatic stay point unmistakably away from any Congressional desire to impose such an additional burden on debtors seeking bankruptcy protection. As the Eighth Circuit wrote,

> [I]f persons who could make no substantial adverse claim to a debtor's property in their possession could, without cost to themselves, compel the debtor or his trustee to bring suit as a prerequisite to returning the property, the powers of a bankruptcy court ... to collect the estate for the benefit of creditors would be vastly reduced.

Knaus v. Concordia Lumber Co. (In re Knaus), 889 F.2d 773, 775 (8th Cir.1989) (internal quotation marks omitted). SEFCU has identified no basis for concluding that Congress intended this result.

The district court's decision in *Alberto* also runs counter to the strong trend of decisions from our sister Circuits. For example, the Seventh Circuit has bluntly ruled that "a plain reading of the Bankruptcy Code's provisions, the Supreme Court's decision in [*Whiting Pools*], and various practical considerations require that a creditor immediately return a seized asset in which a debtor has an equity interest to the debtor's estate upon his filing of Chapter 13 bankruptcy." *Thompson,* 566 F.3d at 700; *see also Knaus,* 889 F.2d at 775. Bankruptcy Appellate Panels from other Circuits agree. *E.g., Unified People's Fed. Credit Union v. Yates (In re Yates),* 332 B.R. 1, 7 (10th Cir. BAP 2005); *TranSouth Fin. Corp. v. Sharon (In re Sharon),* 234 B.R. 676, 682 (6th Cir. BAP 1999); *Abrams v. Sw. Leasing & Rental Inc. (In re Abrams),* 127 B.R. 239, 243 (9th Cir. BAP 1991).

***81** Only the Eleventh Circuit has adopted a contrary approach, and those decisions have largely relied on readings of state law with regard to the relative legal property interests of debtor and secured creditor after a lawful repossession. *See Bell–Tel Fed. Credit Union v. Kalter (In re Kalter),* 292 F.3d 1350, 1356–60 (11th Cir.2002) (applying Florida law); *Charles R. Hall Motors, Inc. v. Lewis (In re Lewis),* 137 F.3d 1280, 1284–85 (11th Cir.1998) (applying Alabama law).

In our view, the majority rule adheres more faithfully to the text of the Bankruptcy Code and the reasoning of *Whiting Pools.* In addition, sound policy supports the majority's reading of the statutory text:

> The primary goal of reorganization bankruptcy is to group *all* of the debtor's property together in his estate such that he may rehabilitate his credit and pay off his debts; this necessarily extends to all property, even property lawfully seized pre-petition. An asset actively used by a debtor serves a greater purpose to both the debtor and his creditors than an asset sitting idle on a creditor's lot.

Thompson, 566 F.3d at 702 (citations omitted) (emphasis in original).

We therefore join the majority of other Circuits to have addressed this issue and conclude that section 362 requires a creditor in possession of property seized as security—but subject to a state-law-based residual equitable interest in the debtor—to deliver that property to the trustee or debtor-in-possession promptly after the debtor has filed a petition in bankruptcy under Chapter 13.

II.

[4] SEFCU argues that even if the Code did not permit SEFCU to await a turnover order before relinquishing the vehicle, SEFCU was entitled to withhold the vehicle until Weber offered or the court ordered Weber to provide SEFCU "adequate protection" for SEFCU's security interest. Appellant's Br. 15. We need not pause long over this argument, for the plain text of the Bankruptcy Code contradicts this position. As we have observed, section 542(a) provides without qualification that

anyone in possession of the property of the estate "shall deliver" it to the trustee. 11 U.S.C. § 542(a). The Code requires the creditor first to surrender the property. Only then or in conjunction with that surrender may it proceed to "request" from the Bankruptcy Court "adequate protection" for its interests. 11 U.S.C. §§ 362(d), 363(e).[8] The provisions authorizing imposition of such protection operate only upon application of the creditor to the Bankruptcy Court. Unlike section 542(a), these are not self-executing.

SEFCU points to no provision of the Code permitting a creditor to withhold property of the estate until the debtor has offered protection that is "adequate" in the *creditor's* view, separate from any formal proceeding before the Bankruptcy Court. Rather, the Code provides for protection ***82** that the *court* deems adequate: "[O]n request of an entity that has an interest in property used ... by the trustee, the court ... shall prohibit or condition such use ... as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e). *See Sharon,* 234 B.R. at 683 (holding that "[t]here is no 'exception' ... that excuses [the creditor's] refusal to deliver possession of the Debtor's car based on [the creditor's] subjective opinion that adequate protection offered by the Debtor was not 'adequate' "). To hold otherwise would permit a creditor holding the debtor's property at the time of the debtor's bankruptcy filing to "negotiat[e] a better security package" than other creditors, thereby ensuring that creditor "a position above other secured creditors" and circumventing the bankruptcy court's authority to approve the debtor's plan to repay his or her debts. *Thompson,* 566 F.3d at 707.

SEFCU points principally to the Fourth Circuit's decision in *Tidewater Finance Co. v. Moffett (In re Moffett),* 356 F.3d 518 (4th Cir.2004), in support of the proposition that a secured creditor may await delivery of what it deems adequate protection before surrendering the debtor's property to the estate. But *Moffett* is inapposite. That case did not concern the creditor's assessment of whether the debtor's proffered protection was "adequate." Rather, there, the creditor moved in the bankruptcy court for relief from the stay, seeking permission to sell the previously repossessed vehicle. *Id.* at 520. The Fourth Circuit agreed with the bankruptcy court that the debtor's reorganization plan provided "adequate protection" to the creditor and declined to lift the stay, requiring the creditor to return the vehicle to the debtor. *Id.* at 523.

We easily conclude that SEFCU's belief that Weber had not provided "adequate protection" for SEFCU's security interest in the vehicle does not cure SEFCU's violation of section 362.

III.

Finally, SEFCU asserts that even if its actions violated section 362, its violation was not "willful" within the meaning of section 362(k), and therefore the court may not require it to pay Weber's damages, costs, or attorneys' fees, or to impose any sanction. SEFCU asserts primarily that, because it relied in good faith on the *Alberto* decision and the "rule and custom" of the Northern District of New York, any violation that it committed should not be deemed "willful" under section 362(k). Appellant's Br. at 3.

We appreciate that, since one district court rendered its decision in *Alberto,* a practice may have developed in the Northern District of New York under which creditors felt entitled to await a turnover order and that SEFCU may therefore have felt justified in failing to surrender Weber's vehicle absent a court order. Nothing prevented SEFCU from surrendering the vehicle in response to Weber's request, however: it always was free to do so, and free concurrently to move the Bankruptcy Court for entry of an order that would—in the *court's* view—provide "adequate protection" to SEFCU. The creditor's error in this regard does not justify placing costs related to the vehicle's retention on the debtor.

[5] [6] Indeed, SEFCU misconstrues the meaning of "willful" as our Circuit law has construed the term in the context of section 362. A creditor willfully violates section 362 when it knows of the filing of the petition (and hence of the automatic stay), and has the general intent simply to perform the act found to violate section 362; no specific intent to violate section 362 is necessary. As we wrote over twenty years ago, "any deliberate act taken in ***83** violation of a stay, which the violator knows

to be in existence, justifies an award of actual damages." *Crysen/Montenay Energy Co. v. Esselen Assocs., Inc. (In re Crysen/Montenay Energy Co.),* 902 F.2d 1098, 1105 (2d Cir.1990); *see also In re Dominguez,* 312 B.R. 499, 508 (Bankr.S.D.N.Y.2004) ("[S]o long as the violator possessed general intent in taking actions which have the effect of violating the automatic stay the intent required by § 362(h) is satisfied."); *Yates,* 332 B.R. at 7 ("Whether the party believes in good faith that it had a right to the property is not relevant to whether the act was willful or whether compensation must be awarded." (internal quotation marks omitted)). Section 362(k) operates to compensate the debtor who has been injured by the violation, in line with the distribution of the procedural burden struck by the statute, as discussed above, in favor of the estate and the bankruptcy mechanism. Because it intended to retain Weber's vehicle, SEFCU acted "willfully," and is liable for damages, costs, and attorney's fees under section 362(k)(1).

Although its good faith is insufficient to excuse SEFCU from liability for Weber's actual damages, it may prevent the imposition of punitive damages, which in any event Weber's counsel has conceded he no longer seeks.[9] *See Crysen/Montenay Energy Co.,* 902 F.2d at 1105 ("An additional finding of maliciousness or bad faith on the part of the offending creditor warrants the further imposition of punitive damages...."); *see also In re Velichko,* 473 B.R. at 69–70 (imposition of punitive damages premised on finding that secured creditor acted in bad faith by forcing debtors to sign reaffirmation agreement before relinquishing their vehicle).

CONCLUSION

For the foregoing reasons, we conclude that by failing to deliver the repossessed vehicle to the debtor-in-possession promptly after receiving notice of the pending petition, SEFCU willfully violated section 362(a), and is liable under section 362(k) for Weber's actual damages, costs, and attorney's fees. The order of the district court is AFFIRMED, and the cause remanded to the district court for further proceedings consistent with this opinion. The district court may, if it chooses, remand the cause to the bankruptcy court for adjudication of the remaining issues, including Weber's costs.

All Citations

719 F.3d 72, 69 Collier Bankr.Cas.2d 1168, Bankr. L. Rep. P 82,484

Footnotes

1 In proceedings before the Bankruptcy Court, the parties submitted a "Combined statement of facts not subject to material dispute," pursuant to Local Rule 7056 of the Bankruptcy Court for the Northern District of New York. We draw the facts presented here from that statement.

2 According to The Daily Gazette, which covers Schenectady and Albany, the State Employees Federal Credit Union officially changed its name to "SEFCU" in 1990. Lee Coleman, *Credit Unions Going Strong in Region,* The Daily Gazette, Apr. 29, 2012, at B1.

3 Section 363, as applicable here, provides: "[U]nless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing." 11 U.S.C. § 363(c)(1); *see also United States v. Whiting Pools, Inc.,* 674 F.2d 144, 149 (2d Cir.1982) (Friendly, *J.*), *aff'd,* 462 U.S. 198, 103 S.Ct. 2309, 76 L.Ed.2d 515 (1983). The trustee may also use, sell, or lease property of the estate outside the ordinary course of business, upon notice and a hearing before the bankruptcy court. 11 U.S.C. § 363(b)(1); *see also Motorola, Inc. v. Official Comm. of Unsecured Creditors and JPMorgan Chase Bank, N.A. (In re Iridium Operating LLC),* 478 F.3d 452, 466 (2d Cir.2007).

4 The debtor-in-possession may exercise many of the rights and powers of a bankruptcy trustee, including the right to use, sell, or

lease property of the estate. 11 U.S.C. §§ 1303, 1304(b) ("Unless the court orders otherwise, a debtor engaged in business may operate the business of the debtor and, subject to any limitations on a trustee under sections 363(c) and 364 of this title and to such limitations or conditions as the court prescribes, shall have, exclusive of the trustee, the rights and powers of the trustee under such sections.").

[5] The iconic description of the overriding purpose of section 362 is drawn directly from the section's legislative history:

> The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.

H.R.Rep. No. 95–595, at 340–41 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6296–97; *see also United States v. Colasuonno*, 697 F.3d 164, 172 (2d Cir.2012).

[6] In relevant part, section 541 provides:

> (a) The commencement of a case under [11 U.S.C. §§ 301, 302, or 303] creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) [Subject to exceptions not relevant here,] all legal or equitable interests of the debtor in property as of the commencement of the case.

[7] Weber retained other rights under state law consistent with his status as the equitable owner of the vehicle. These rights included a right to notification before the creditor disposed of the vehicle, N.Y. U.C.C. § 9–611, and a right to receive any surplus from the sale of the vehicle, *id.* § 9–615(d)(1). In addition, we observe that Weber may have retained legal title to the vehicle. *See, e.g.,* N.Y. U.C.C. § 9–609; N.Y. Veh. & Traf. Law § 2115. But the parties have not briefed this question and we do not decide it here. That Weber has a colorable claim to have retained legal title to the truck, in addition to his acknowledged equitable interests in the vehicle, arguably serves to distinguish this case, however, from those in which legal title transferred to the creditor automatically upon repossession (or never was in the debtor to begin with). We express no view about the bearing of section 362 upon the latter situations.

[8] In relevant part, section 362(d) provides:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—(1) for cause, including the lack of adequate protection of an interest in property of such party in interest.

In relevant part, section 363(e) provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased ... by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale or lease as is necessary to provide adequate protection of such interest.

[9] At oral argument, Weber's counsel confirmed that Weber does not seek punitive damages.

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849 F.3d 943
United States Court of Appeals,
Tenth Circuit.

IN RE: Jared Trenton COWEN, Debtor.
WD Equipment, LLC; Aaron Williams; Bert Dring, Appellants,
v.
Jared Trenton Cowen, Appellee.

No. 15-1413
|
Filed February 27, 2017

Synopsis
Background: Chapter 13 debtor brought adversary proceeding to recover for creditors' allegedly willful violations of automatic stay in refusing to return collateral repossessed prepetition. Following dismissal of underlying bankruptcy case, the United States Bankruptcy Court for the District of Colorado entered judgment in favor of debtor and awarded both compensatory and punitive damages. Creditors appealed. The District Court, Robert E. Blackburn, J., 549 B.R. 774, affirmed in part and reversed in part, and creditors appealed.

Holdings: The Court of Appeals, McKay, Circuit Judge, held that:

[1] stay provision prohibiting any postpetition act to "obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" prohibited only affirmative acts to gain possession of, or to exercise control over, estate property, and did not prohibit secured creditors from passively retaining possession of collateral repossessed prepetition; abrogating *In re Yates*, 332 B.R. 1, but

[2] to extent that creditors manufactured paperwork postpetition in attempt to demonstrate that debtor's rights in collateral had terminated prepetition, they would have violated stay.

Reversed and remanded.

West Headnotes (14)

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

On appeal from district court's decision in its bankruptcy appellate capacity, the Court of Appeals reviews bankruptcy court's decision independently, examining legal determinations de novo and factual findings for clear error. Fed. R. Bankr. P. 8013.

Cases that cite this headnote

[2] **Bankruptcy** Scope of review in general

Bankruptcy Appellate Panel's or district court's rulings in their bankruptcy appellate capacity are not entitled to any deference on subsequent appeal to the Court of Appeals; however, they may certainly be persuasive.

Cases that cite this headnote

[3] **Bankruptcy** Limited, in personam, and in rem jurisdiction

Jurisdiction of bankruptcy courts, like that of other federal courts, is grounded in, and limited by, statute. 28 U.S.C.A. § 1334(b).

Cases that cite this headnote

[4] **Bankruptcy** Stay enforcement

Claim for damages for violation of automatic stay is "core" proceeding, which bankruptcy court had statutory authority to adjudicate to final judgment. 11 U.S.C.A. § 362(k)(1); 28 U.S.C.A. § 157(b).

2 Cases that cite this headnote

[5] **Bankruptcy** Effect of dismissal or closing of case

Bankruptcy court retained jurisdiction to adjudicate claim for damages for allegedly willful violation of automatic stay even after underlying Chapter 13 case was dismissed. 11 U.S.C.A. § 362(k)(1).

Cases that cite this headnote

[6] **Bankruptcy** Stay enforcement

Mere fact that bankruptcy court, in order to determine whether secured creditors had willfully violated automatic

stay and were liable in damages, first had to determine whether debtor's rights in collateral had been validly terminated prepetition in accordance with governing state law did not affect "core" nature of proceeding, as one which bankruptcy court could adjudicate to final judgment. 11 U.S.C.A. § 362(k)(1); 28 U.S.C.A. § 157(b)(3).

Cases that cite this headnote

[7] **Bankruptcy** Stay enforcement
Bankruptcy Bankruptcy judges

Claim for damages for allegedly willful violation of automatic stay stemmed directly from bankruptcy itself, and was claim which bankruptcy court, even as non-Article-III court, had constitutional authority to adjudicate. U.S. Const. art. 3, § 1 et seq.

2 Cases that cite this headnote

[8] **Bankruptcy** Automatic Stay

When debtor files for bankruptcy, automatic stay prevents creditors from taking further action against him except through bankruptcy court. 11 U.S.C.A. § 362(a).

Cases that cite this headnote

[9] **Bankruptcy** Repossession

Stay provision prohibiting any postpetition act to "obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate" prohibited only affirmative acts to gain possession of, or to exercise control over, estate property, and did not prohibit secured creditors from passively retaining possession of collateral which they had repossessed prepetition or require creditors to promptly return this property to debtor once notified of his Chapter 13 filing; abrogating *In re Yates*, 332 B.R. 1. 11 U.S.C.A. § 362(a)(3).

4 Cases that cite this headnote

[10] **Bankruptcy** Construction and Operation

Interpretation of the Bankruptcy Code starts where all such inquiries must begin, with language of statute itself. 11 U.S.C.A. § 101 et. seq.

Cases that cite this headnote

[11] **Statutes** Plain Language; Plain, Ordinary, or Common Meaning

When statute's language is plain, sole function of courts is to enforce it according to its terms.

2 Cases that cite this headnote

[12] **Statutes** Nature and Definition of Legislative Acts

Congress does not hide elephants in mouseholes.

Cases that cite this headnote

[13] **Bankruptcy** Carrying out provisions of Code
Bankruptcy Frivolity or bad faith; sanctions

Bankruptcy statute authorizing courts to issue "necessary or appropriate" orders grants bankruptcy courts the power to sanction conduct abusive of the judicial process. 11 U.S.C.A. § 105(a).

1 Cases that cite this headnote

[14] **Bankruptcy** Proceedings, Acts, or Persons Affected
Bankruptcy Repossession

While secured creditors did not engage in any affirmative conduct to "obtain possession of" or to "exercise control over" property of the estate, in violation of automatic stay, by passively retaining collateral which they had repossessed prepetition, to extent that they manufactured paperwork postpetition in attempt to demonstrate that debtor's rights in collateral had terminated prepetition, or to extent that they forged documents, gave perjured testimony, or coached witnesses in attempt to convince court that debtor's rights in collateral had ended, such conduct would constitute affirmative postpetition acts to exercise control over debtor's property in violation of automatic stay. 11 U.S.C.A. § 362(a)(3).

3 Cases that cite this headnote

***945 Appeal from the United States District Court for the District of Colorado (D.C. No. 1:14-CV-02408-REB)**

Attorneys and Law Firms

Alexander M. Musz of Cohen & Cohen, P.C., Denver, Colorado, for Defendants–Appellants.

C. Todd Morse of Morse Law, LLC, Denver, Colorado, for Plaintiff–Appellee.

Before KELLY, McKAY, and McHUGH, Circuit Judges.

Opinion

McKAY, Circuit Judge.

Plaintiff Jared Trent Cowen's 2000 Peterbilt 379, a commercial truck, was in need of repair. To cover the cost, Mr. Cowen borrowed money from Defendant WD Equipment, which is owned and managed by Defendant Aaron Williams, in exchange for a lien on the truck and the promise of repayment. After the Peterbilt broke down again only a few weeks after the repairs, it was towed to a local repair company, which estimated that fixing the truck again would cost $9,000—more than Mr. Cowen could afford.

Because his Peterbilt was in the shop, Mr. Cowen could not make installment payments to WD Equipment. So, in early August, 2013, Mr. Cowen began taking steps to refinance the loan; he met with his bank and with his parents in an attempt to secure refinancing, and he exchanged several text messages on August 1 and 2 with Mr. Williams about paying off the loan. During the course of that exchange, however, Mr. Williams gave Mr. Cowen several, contradictory responses as to how much Mr. Cowen would need to pay to settle the debt, and he accelerated the payoff date several times, before ultimately setting August 6 as the deadline.

Around the same time, Mr. Cowen defaulted on another loan secured by another one of his trucks, a 2006 Kenworth T600. This loan was owed to Defendant Bert Dring, the father-in-law of Mr. Williams, who held a purchase-money security interest in the truck. On July 29, Mr. Dring lured Mr. Cowen under false pretenses to his place of business to repossess the Kenworth. Mr. Dring asked Mr. Cowen, who had brought along his young son, to leave the keys in the ignition, engine running, and to step out of the truck. As Mr. Cowen exited the vehicle, Mr. Dring jumped in, grabbed the keys, and declared the truck "repossessed." When Mr. Cowen asked what was going on, Mr. Dring told him to take his son and leave—immediately. A group of five men gathered around Mr. Dring while he brandished a can of mace above his head and threatened to use it if Mr. Cowen did not leave. Mr. Cowen pushed his young son behind him to protect him, and the two left the lot on foot. Three days later, Mr. Cowen received a letter from Mr. Dring giving him ten days to pay off the Kenworth.

***946** Instead, Mr. Cowen filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code on August 6, which was the deadline for paying off the Peterbilt, and which was within the ten-day cure period for the Kenworth. He notified Defendants of the filing and requested the immediate return of both trucks. But Defendants refused: Mr. Williams claimed that he had changed the title to his name on August 1. (At no time during the text message exchanges on August 1 and 2 did Mr. Williams ever inform Mr. Cowen of the title change.) And Mr. Dring claimed that he sold the Kenworth sometime prior to the bankruptcy filing. (Initially, he claimed he had sold the Kenworth to an unknown Mexican national for cash in an undocumented sale just days before Mr. Cowen filed for bankruptcy. Later, Mr. Dring produced bill of sale, purporting to show that he sold the Kenworth to a Mr. Garcia for $16,000 in cash on August 4.)

About a month later, Mr. Cowen moved the bankruptcy court for orders to show cause why Defendants should not be held in contempt for willful violations of the automatic stay. The bankruptcy court granted the motions and ordered Defendants to

"immediately turn over" the trucks to Mr. Cowen; "[c]ontinuing failure to turn over the Truck[s]," the bankruptcy court warned, "may result in the imposition of monetary damages against the Creditors for willful violation of the automatic stay." Order on Motion for Order to Show Cause and Order to Turnover Property of the Estate, Case No. 13-23461 (Bankr. Colo. Sept. 5, 2013).

When Defendants did not comply with the bankruptcy court's turnover order, Mr. Cowen filed an adversary proceeding for violations of the automatic stay. A few months later, the bankruptcy court dismissed the underlying bankruptcy case because, without the trucks, Mr. Cowen had no regular income, which rendered him ineligible for Chapter 13 relief. However, the bankruptcy court expressly retained jurisdiction over the adversary proceeding.

During the adversary proceeding, Defendants again asserted that Mr. Cowen's rights in the trucks had been properly terminated by Defendants *before* the bankruptcy petition was filed, and so they could not have violated the automatic stay. But the bankruptcy court "did not find the Defendants' testimony that they had transferred title before the petition date to be credible." (App. Vol. II at 248.) It went on to "find[ ] that they manufactured the paperwork ... after the bankruptcy filing." (*Id*.) "Defendants likely forged documents and gave perjured testimony" and "coached their witnesses on what to testify to during [ ] breaks" in an "attempt to convince the Court that [Mr. Cowen's] rights in the Trucks had been terminated prebankruptcy." (*Id.* at 258.) Additionally, the bankruptcy court held that "even if they had taken the actions they claim to have taken before the bankruptcy filing," (*id.* at 269), such actions contravened Colorado law, and therefore did not effectively terminate Mr. Cowen's "ownership interest in the Trucks," (*id.* at 252). And so, the bankruptcy court concluded, "[f]ailing to return the Trucks violated § 362(a)(3) of the Bankruptcy Code," (*id.*), and it imposed actual and punitive damages under 11 U.S.C. § 362(k)(1).

[1] [2]Defendants timely appealed this decision to the district court, which reversed on the calculation of damages but otherwise affirmed the bankruptcy court's order. Defendants then appealed to this Court, arguing, among other things, that the bankruptcy court exceeded its jurisdiction, that it lacked constitutional authority to enter a final judgment in this adversary proceeding, and that the bankruptcy court misinterpreted § 362—the automatic stay ***947** provision. "[T]hough this appeal comes to us from the district court, we review a bankruptcy court's decisions independently, examining legal determinations de novo and factual findings for clear error." *FB Acquisition Prop. I, LLC v. Gentry (In re Gentry)*, 807 F.3d 1222, 1225 (10th Cir. 2015). "In doing so, we treat the bankruptcy appellate panel or district court as a subordinate appellate tribunal whose rulings are not entitled to any deference (although they may certainly be persuasive)." *Nelson v. Long (In re Long)*, 843 F.3d 871, 873 (10th Cir. 2016) (internal quotation marks omitted). "A bankruptcy court's legal conclusions are reviewed de novo, while its factual findings are reviewed for clear error." *Id.*

[3] [4]We address first the bankruptcy court's jurisdiction. "The jurisdiction of the bankruptcy courts, like that of other federal courts, is grounded in, and limited by, statute." *Celotex Corp. v. Edwards*, 514 U.S. 300, 307, 115 S.Ct. 1493, 131 L.Ed.2d 403 (1995). By statute, bankruptcy courts have jurisdiction to "enter final judgments in 'all core proceedings arising under title 11, or arising in a case under title 11.' " *Stern v. Marshall*, 564 U.S. 462, 474, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011) (quoting 28 U.S.C. § 157(b)(1)). As we have explained, a claim for damages under § 362(k)(1) for a violation of an automatic stay is a core proceeding. *Johnson v. Smith (In re Johnson)*, 575 F.3d 1079, 1083 (10th Cir. 2009) (holding that a "§ 362(k)(1) proceeding ... is a core proceeding because it derives directly from the Bankruptcy Code and can be brought only in the context of a bankruptcy case." (internal quotation marks and brackets omitted)). Accordingly, bankruptcy courts can exercise jurisdiction and adjudicate such claims to final judgment. *Id.*

[5]Defendants contend, however, that the bankruptcy court erred in retaining jurisdiction over the § 362(k)(1) adversary proceeding after the underlying bankruptcy was dismissed. But this argument is foreclosed by *Johnson*. There it was argued that "dismissal of the underlying Chapter 13 case divested the bankruptcy court of jurisdiction over the § 362(k)(1) proceeding." *Id.* at 1081. We disagreed: "Nothing in the Bankruptcy Code mandates dismissal of the § 362(k)(1) proceeding when the bankruptcy case is closed," and "[n]o part of § 362(k)(1) suggests that a claim exists only while the bankruptcy case remains pending." *Id.* at 1084. We explained that "[r]equiring the dismissal of a § 362(k)(1) proceeding simply because the underlying bankruptcy case has been dismissed would not make sense. A court must have the power to compensate victims of violations of the automatic stay and punish the violators, even after the conclusion of the underlying bankruptcy case." *Id.* at 1083.

[6]Defendants' attempts to distinguish *Johnson* are unavailing. They argue that, unlike in *Johnson*, this § 362(k)(1) adversary proceeding is "non-core" because the bankruptcy court "had to determine the disputed possessory interests in [the] assets pursuant to state law." (Appellant's Br. at 36). But "[a] determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State law." 28 U.S.C. § 157(b)(3).

Defendants also seem to suggest that *Johnson* is distinguishable because there the bankruptcy court decided the automatic stay violation first, which was appealed (which, in turn, resulted in a remand), and *then* dismissed the underlying bankruptcy while the automatic stay violation appeal was pending. (*See* Appellant's Br. at 34 (citing *Johnson*, 575 F.3d at 1081, where we summarized the procedural history of the case)). But Defendants do not argue, ***948** much less persuade, why this discrepancy undermines the unequivocal holding of *Johnson*: "a § 362(k)(1) proceeding remains viable after termination of the underlying bankruptcy case." *Johnson*, 575 F.3d at 1084.

[7]Defendants also contend that the bankruptcy court lacked constitutional authority under *Stern v. Marshall* to enter final judgment. But *Stern* dealt with claims that did not "stem[ ] from the bankruptcy itself" and would not "necessarily be resolved in the claims allowance process." *Stern*, 564 U.S. at 499, 131 S.Ct. 2594. A claim under § 362(k)(1) for an automatic stay violation, by contrast, "derives directly from the Bankruptcy Code and can be brought only in the context of a bankruptcy case." *Johnson*, 575 F.3d at 1083. Indeed, it necessarily "stems from the bankruptcy itself." *Stern*, 564 U.S. at 499, 131 S.Ct. 2594.

A claim for violating an automatic stay is not the "stuff of the traditional actions at common law tried by the courts at Westminster in 1789." *Stern*, 564 U.S. at 484, 131 S.Ct. 2594 (quoting *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 90, 102 S.Ct. 2858, 73 L.Ed.2d 598 (1982) (Rehnquist, J., concurring in the judgment)). To the contrary, "we are concerned here with the adjudication of a right created by federal statute, rather than a private, state-created right, like that of concern in *Marathon*." *Mountain America Credit Union v. Skinner (In re Skinner)*, 917 F.2d 444, 449 (10th Cir. 1990) (holding that a bankruptcy court did not exceed its constitutional authority when it entered sanctions pursuant to 11 U.S.C. § 362(h), the precursor of § 362(k), for violating an automatic stay). And so, the bankruptcy court did not exceed its constitutional authority by entering final judgment in the § 362(k)(1) adversary proceeding.

[8]To the merits. Mr. Cowen filed the adversary proceeding against Defendants for violating "[s]ection 362, which establishes the automatic stay." *Johnson*, 575 F.3d at 1083. "When a debtor files for bankruptcy, section 362 prevents creditors from taking further action against him except through the bankruptcy court." *Id.* (quoting *Price v. Rochford*, 947 F.2d 829, 831 (7th Cir. 1991)). To accomplish this, § 362 provides in relevant part that a bankruptcy petition "operates as a stay ... of ... any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3).

[9]Below, the bankruptcy court held that "[t]he failure to return the Trucks to [Mr. Cowen] post-petition constituted a continuing violation of the stay"; specifically, Defendants "violated § 362(a)(3) of the Bankruptcy Code." (App. Vol. II at 252.) As the district court noted, the bankruptcy court applied what appears to be the majority rule: "that the act of passively holding onto an asset constitutes 'exercising control' over it, and such action violates section 362(a)(3) of the Bankruptcy Code." *Thompson v. Gen. Motors Acceptance Corp.*, 566 F.3d 699, 703 (7th Cir. 2009); *see also Weber v. SEFCU (In re Weber)*, 719 F.3d 72, 81 (2d Cir. 2013), *California Emp't Dev. Dep't v. Taxel (In re Del Mission Ltd.)*, 98 F.3d 1147, 1151 (9th Cir. 1996), *Knaus v. Concordia Lumber Co. (In re Knaus)*, 889 F.2d 773, 775 (8th Cir. 1989), *Unified People's Fed. Credit Union v. Yates (In re Yates)*, 332 B.R. 1, 4 (10th Cir. BAP 2005); *but see United States v. Inslaw*, 932 F.2d 1467, 1474 (D.C. Cir. 1991). Defendants disagree with this interpretation of § 362(a)(3), and we agree with Defendants.

[10] [11]The majority rule seems driven more by "practical considerations," ***949** *Weber*, 719 F.3d at 80, and "policy considerations," *Thompson*, 566 F.3d at 703, than a faithful adherence to the text. But "[o]ur interpretation of the Bankruptcy Code starts where all such inquiries must begin: with the language of the statute itself." *Ransom v. FIA Card Servs., N.A.*, 562 U.S. 61, 69, 131 S.Ct. 716, 178 L.Ed.2d 603 (2011) (internal quotation marks omitted). In this case, it is also where the inquiry ends, "for where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *Frieouf v. United States (In re Frieouf)*, 938 F.2d 1099, 1102–03 (10th Cir. 1991).

Here again is § 362(a)(3), in relevant part: a bankruptcy petition "operates as a stay ... of ... any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Breaking down the sentence, "any act" is the prepositive modifier of both infinitive phrases. In other words, § 362(a)(3) prohibits "any act to obtain possession of property" or "any act to exercise control over property." "Act", in turn, commonly means to "take action" or "do something." *New Oxford American Dictionary* 15 (3d ed. 2010) (primary definition of "act"). This section, then, stays entities from *doing* something to obtain possession of or to exercise control over the estate's property. It does not cover "the act of passively holding onto an asset," *Thompson*, 566 F.3d at 703, nor does it impose an affirmative obligation to turnover property to the estate. "The automatic stay, as its name suggests, serves as a restraint only on acts to gain possession or control over property of the estate." *Inslaw*, 932 F.2d at 1474. Stay means stay, not go.

The majority rule reads too much into the section's legislative history. Prior to the Bankruptcy Amendments and Federal Judgeship Act of 1984, "the Code's stay provision only prohibited any act to obtain possession of property belonging to a bankruptcy estate." *Thompson*, 566 F.3d at 702. The 1984 Amendments "broadened the already sweeping provisions of the automatic stay even further to prohibit expressly not only 'acts to obtain possession' of property of the estate, but also 'any act ... to exercise control over the property of the estate.' " *Weber*, 719 F.3d at 80 (quoting Pub. L. No. 98–353, 98 Stat. 333, 371). Notwithstanding that "Congress did not provide an explanation of that amendment," the majority reads from "the mere fact that Congress expanded the provision to prohibit conduct above and beyond obtaining possession of an asset," that Congress "intended to prevent creditors from retaining property of the debtor." *Weber*, 719 F.3d at 80. "This significant textual enlargement is consonant with [the majority rule]." *Id.*

[12]But Congress does not "hide elephants in mouseholes." *Whitman v. American Trucking Ass'ns*, 531 U.S. 457, 468, 121 S.Ct. 903, 149 L.Ed.2d 1 (2001). The amendments are equally "consonant" with another, less sweeping conclusion. "Since an act designed to change control of property could be tantamount to obtaining possession and have the same effect, it appears that § 362(a)(3) was merely tightened to obtain full protection." *In re Bernstein*, 252 B.R. 846, 848 (Bankr. D.D.C. 2000). "[U]se of the word 'control' in the 1984 amendment to § 362(a)(3) suggests that the drafters meant to distinguish the newly prohibited 'control' from the already-prohibited acts to obtain 'possession,' in order to reach nonpossessory conduct that would nonetheless interfere with the estate's authority over a particular property interest." Ralph Brubaker, ***950** *Turnover, Adequate Protection, and the Automatic Stay (Part II): Who is "Exercising Control" Over What?*, 33 No. 9 Bankruptcy Law Letter NL 1 (September 2013).

It's not hard to come up with examples of such "acts" that "exercise control" over, but do not "obtain possession of," the estate's property, e.g., a creditor in possession who improperly sells property belonging to the estate. Similarly, "intangible property rights that belong to the estate, such as contract rights or causes of action are incapable of real possession unless they are reified. Yet, (a)(3) preserves and guards against interference with them by staying any act to exercise control over estate property." *In re Hall*, 502 B.R. 650, 665 (Bankr. D.D.C. 2014). If Congress had meant to add an affirmative obligation—to the automatic *stay* provision no less, as opposed to the *turnover* provision—to turn over property belonging to the estate, it would have done so explicitly. The majority rule finds no support in the text or its legislative history.

In the end, the best argument for the majority rule is that § 362 should be read in conjunction with another part of the bankruptcy code—§ 542, the turnover provision, which provides that any entity "in possession, custody, or control, during the case of property that the trustee may use, sell, or lease under section 363 of this title ... *shall* deliver" such property to the trustee "unless such property is of inconsequential value or benefit to the estate." 11 U.S.C. § 542 (emphasis added). According to the majority, "Section 542 requires that any entity in possession of property of the estate deliver it to the trustees, without condition or any further action: the provision is self-executing." *Weber*, 719 F.3d at 79 (internal quotation marks omitted); *but see Hall*, 502 B.R. at 654–665. Reading these two sections together ostensibly furthers "[t]he primary goal of ... bankruptcy," *Thompson*, 566 F.3d at 702, i.e. "to group all of the debtor's property together," *id.* because "[a]s a practical matter, there is little difference between a creditor who obtains property of the estate before bankruptcy is filed, or after bankruptcy is filed," *Yates*, 332 B.R. at 5. "The ultimate result is the same—the estate will be deprived of possession of that property," which is "precisely the result § 362 seeks to avoid." *Id.* And so, the argument goes, "§ 542 provides the right to the return of estate property, while [§ 362] provides the remedy for the failure to do so." *Abrams v. Sw. Leasing & Rental, Inc. (In re Abrams)*, 127 B.R. 239, 242–43 (9th Cir. BAP 1991).

[13]But this policy argument, too, is simply not supported by the statute's text or its legislative history. Even if the turnover provision were "self-executing" (which we do not decide), there is still no textual link between § 542 and § 362. And, contrary to one argument for the majority rule, *see id.* at 243, bankruptcy courts do not need § 362 to enforce the turnover of property to the estate. Bankruptcy courts have "broad equitable powers" under 11 U.S.C. § 105(a), *see Scrivner v. Mashburn (In re Scrivner)*, 535 F.3d 1258, 1263 (10th Cir. 2008), and can provide equitable relief as "necessary or appropriate to carry out the provisions of" § 542(a), *see id.* (citing 11 U.S.C. § 105(a)). Moreover, § 105(a) "grants bankruptcy courts the power to sanction conduct abusive of the judicial process." *Id.* (internal brackets and quotation marks omitted); *see also Skinner*, 917 F.2d at 447 (holding that "section 105(a) empowers bankruptcy courts to enter civil contempt orders," including for monetary damages). And so, adhering to the text of the statute, as we must, we adopt the minority rule: only affirmative acts to gain possession of, or to exercise control over, property of the estate violate § 362(a)(3).

[14] ***951** Today's decision does not absolve Defendants of liability, however. On remand, the damages award may be sustainable under the proper application of § 362(a)(3) and under § 105(a), which "grants bankruptcy courts the power to sanction conduct abusive of the judicial process." *Scrivner*, 535 F.3d at 1263. The bankruptcy court here "found the Defendants' attitudes while testifying to be contemptuous of the bankruptcy process, the Debtor, and the Court." (App. Vol. II at 258). It also found that Defendants "manufactured the paperwork ... after the bankruptcy filing." (*Id*. at 248.). And it noted that Defendants "likely forged documents and gave perjured testimony," and "coached their witnesses on what to testify to during [ ] breaks." (*Id*. at 258). This was all done in an "attempt to convince the Court that [Mr. Cowen's] rights in the Trucks had been terminated prebankruptcy." (*Id.*) These would qualify as post-petition acts to exercise control over the debtor's property in violation of the automatic stay.

We **REVERSE** the judgement of the district court and **REMAND** to the district court, which may remand the case to the bankruptcy court, for further proceedings consistent with this opinion. We **GRANT** the renewed motion to seal volume five of the appendix.

All Citations

849 F.3d 943, 77 Collier Bankr.Cas.2d 438, 63 Bankr.Ct.Dec. 211

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Circuit Split Widens on Stay Violation for Failure to Turn Over Repossessed Collateral

"Tenth Circuit joins the minority by holding that passive retention of collateral is no stay violation."

The Tenth Circuit widened an existing split among the courts of appeals by ruling that passively holding an asset of the estate, in the face of a demand for turnover, does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate."

The Tenth Circuit allied itself with the District of Columbia Circuit. The Seventh, Second, Ninth and Eighth Circuits are arrayed on the other side and hold that retention of estate property after demand for turnover does violate the automatic stay.

Taking the minority position, the Feb. 27 opinion authored by Circuit Judge Monroe G. McKay was based on the plain meaning of the statute, not on "policy considerations."

Before bankruptcy, a lender repossessed the debtor's truck. After filing a chapter 13 petition, the debtor requested the return of the truck. The creditor refused, claiming he had sold the truck before the bankruptcy filing.

A month later, the debtor moved to hold the creditor in contempt for willful violation of the automatic stay. The bankruptcy court granted the motion and directed the creditor to turn the truck over immediately, coupled with a warning that failure to do so could result in imposition of monetary damages for willful violation of the stay under Section 362(k)(1).

When the creditor did not comply, the debtor initiated an adversary proceeding. At trial, the creditor contended there was no stay violation because the debtor's ownership interest was terminated by the sale before bankruptcy.

The bankruptcy judge ruled that documents showing a sale of the truck were "likely forged." The judge also said that the creditor "gave perjured testimony." Even if the testimony were correct, the bankruptcy judge held that the debtor's ownership had not been terminated properly under Colorado law.

The bankruptcy judge concluded that the creditor violated Section 362(a)(3) and imposed actual and punitive damages under Section 362(k)(1). On appeal, the district court set aside the calculation of damages but otherwise upheld the bankruptcy court.

The creditor came out on top in the Tenth Circuit in terms of statutory interpretation, but it might not escape sanctions.

Judge McKay described the "majority rule" as saying that "'the act of passively holding onto an asset constitutes "exercising control" over it, and such action violates Section 362(a)(3),'" quoting the Seventh Circuit in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699, 703 (7th Cir. 2009). He described the majority as "driven more" by "practical" and "policy considerations" than by "faithful adherence to the text."

Concluding that the language of the statute is "plain," Judge McKay aligned the Tenth Circuit with the D.C. Circuit's *U.S. v. Inslaw*, 932 F.2d 1467 (D.C. Cir. 1991).

Observing that the statute bars "any act to exercise control over property," Judge McKay said that "act" means "to 'take action' or 'do something.'" Because the stay enjoins "doing something," he said, "It does not cover 'the act of passively holding onto an asset.'"

Significantly also, Judge McKay said that Section 362(a)(3) does not "impose an affirmative obligation to turnover property."

Judge McKay conceded that the majority's "best argument" is for reading Section 362(a)(3) in tandem with Section 542, which provides that someone in "control" of estate property "shall deliver" it to the trustee. Arguably, Section 542 provides a right to return, while Section 362 imposes a sanction for failure to do so.

Judge McKay said that the majority's "policy argument" in combining the two sections "is simply not supported by the statute's text or its legislative history," in part because there is "no textual link between Section 542 and Section 362."

The opinion adopted "the minority rule: only affirmative acts to gain possession of, or to exercise control over, property of the estate violate Section 362(a)(3)."

Judge McKay said that his statutory interpretation may not absolve the creditor of liability for damages. On remand, he instructed the bankruptcy court to employ Sections 362(a)(3) and 105(a), which give power to "'sanction conduct abusive of the judicial process.'"

He said that the bankruptcy court's finding that the creditor likely forged documents and gave perjured testimony "would qualify as post-petition acts to exercise control over the debtor's property in violation of the automatic stay."

The Tenth Circuit does not seem to undercut the notion that the debtor retains the right to recover possession of repossessed property if title has not transferred. The opinion could be interpreted to mean that a creditor need not heed a demand for turnover but may await entry of a turnover order.

Consequently, debtors who lose possession of their cars before filing may now be obliged in the Tenth Circuit to initiate legal proceedings to recover possession. In other circuits, bankruptcy has the virtue of enabling debtors to recover repossessed autos immediately because lenders know they face contempt sanctions if they do not cooperate.

The opinion has a beneficial feature: It removes the need for courts to explain why a bank's "administrative freeze" does not violate the automatic stay.

The opinion includes a holding favorable to debtors. In the case at hand, the bankruptcy court dismissed the chapter 13 petition because loss of the truck bereft the debtor of ability to generate regular income.

Judge McKay held that jurisdiction to impose damages under Section 362(k) continues after dismissal because a "'court must have the power to compensate victims of violations of the automatic stay and punish violators, even after the conclusion of the underlying bankruptcy case,'" citing *Johnson v. Smith (In re Johnson)*, 575 F.3d 1079, 1083 (10th Cir. 2009).

Opinion Link:	Opinion Link
Judge Name:	Monroe G. McKay
Case Citation:	WD Equipment v. Cowen (In re Cowen), 15-1413 (10th Cir. Feb. 27, 2017)
Case Name:	In re Cowen
Case Type:	Consumer
Court:	10th Circuit
Bankruptcy Tags:	Automatic Stay Bankruptcy Litigation Practice and Procedure Consumer Bankruptcy Business Reorganization

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3. JUDGE MADELEINE WANSLEE

Topic: Marijuana related businesses/employment — how attenuated must the source of revenue be for access to the federal courts? (Not just landlords, growers, etc. but also the janitor of a dispensary that wants to file chapter 13 and fund a plan with his wages, etc.).

Arm Ventures, LLC, 564 B.R. 77 (2017)
26 Fla. L. Weekly Fed. B 221

564 B.R. 77
United States Bankruptcy Court,
S.D. Florida,
Miami Division.

ARM VENTURES, LLC, Debtor(s).

CASE NO. 16–23633–BKC–LMI
|
Signed February 14, 2017

Synopsis
Background: Secured creditor moved to dismiss debtor's Chapter 11 case as having been filed in "bad faith," or in alternative, for relief from automatic stay.

Holdings: The Bankruptcy Court, Laurel M. Isicoff, Chief Judge, held that:

[1] while Chapter 11 case filed by debtor presented numerous indicia of bad faith, as case filed on eve of state court foreclosure sale by single-asset debtor whose prospects for reorganizing depended on highly speculative possibility that its tenant would be approved for sale of medical marijuana, bankruptcy court would not dismiss case due to presence of significant non-insider unsecured claims, but

[2] "cause" existed to lift stay based on debtor's bad faith.

So ordered.

West Headnotes (6)

[1] **Bankruptcy** 'Bad faith.'

"Cause" for dismissal of Chapter 11 case under "for cause" provision includes debtor's bad faith in filing of bankruptcy petition. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[2] **Bankruptcy** Abuse of judicial process
Bankruptcy Frustration or delay of creditors

In determining whether to dismiss Chapter 11 case as having been filed in bad faith, court must consider factors that evidence an intent to abuse the judicial process and the purposes of Chapter 11 reorganization provisions, such as whether there is absence of any realistic possibility of an effective reorganization and whether it is evident that debtor is seeking merely to delay or frustrate legitimate efforts of secured creditors to enforce their rights. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[3] **Bankruptcy** 'Bad faith.'

Among factors that court may consider in deciding whether to dismiss Chapter 11 case as having been filed in bad faith are the following: (1) that debtor has only one asset; (2) that debtor has few unsecured creditors whose claims are small in relation to claims of the secured creditors; (3) that debtor has few employees; (4) that debtor's property is the subject of foreclosure action as result of arrearages on debt; (5) that debtor's financial problems involve essentially a dispute between debtor and secured creditors which can be resolved in pending state court action; and (6) fact that timing of debtor's bankruptcy filing evidences an intent to delay or frustrate legitimate efforts of secured creditors to enforce their rights. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[4] **Bankruptcy** 'Bad faith.'

While Chapter 11 case filed by debtor presented numerous indicia of bad faith, as case filed on eve of state court foreclosure sale by single-asset debtor whose prospects for reorganizing depended on highly speculative possibility that its tenant would be approved for sale of medical marijuana, bankruptcy court would not dismiss case under "for cause" provision, where there were significant non-insider unsecured claims and court was not yet convinced that dismissal was in best interests of those creditors. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[5] **Bankruptcy** Good faith and legality

Proposed Chapter 11 plan that is to be funded through income generated from sale of marijuana products cannot be confirmed unless the business generating the income is legal under both state law and federal law.

Cases that cite this headnote

[6] **Bankruptcy** Fraud, bad faith, or misconduct

As alternative to dismissing, as "bad faith" filing, a Chapter 11 case filed on eve of state court foreclosure sale by single-asset debtor whose prospects for reorganizing depended on highly speculative possibility that its tenant would be approved for sale of medical marijuana, bankruptcy court would grant creditor whose claim was secured by this one asset, a commercial office building, relief from automatic stay; same factors that weighed in favor of dismissal of case as "bad faith" filing also supported relief from stay based on debtor's bad faith. 11 U.S.C.A. §§ 362(d)(1), 1112(b).

Cases that cite this headnote

Attorneys and Law Firms

***78** Mark S. Roher, Esq., Law Office of Mark S. Roher, P.A., Fort Lauderdale, FL, for Debtor(s).

MEMORANDUM OPINION ON ORDER CONDITIONALLY GRANTING OCEAN BANK'S MOTION FOR RELIEF FROM STAY BUT DENYING OCEAN BANK'S REQUEST FOR DISMISSAL

Laurel M. Isicoff, Chief United States Bankruptcy Judge

This matter came before me on December 8, 2016, at 1:30 p.m. upon Ocean Bank's Motion for Entry of an Order (I) Dismissing the Debtor's Chapter 11 Case or, Alternatively, (II) Granting Relief from the Automatic Stay (the "Motion") (ECF # 55). Having considered the pleadings,[1] other matters filed on the docket, the applicable law, and the arguments of counsel, for the reasons set forth below, the Motion to Dismiss is DENIED without prejudice; the Motion for Relief from Stay is GRANTED subject to the conditions outlined herein and in the Order Denying Ocean Bank's Motion for Entry of an Order Dismissing the Debtor's Chapter 11 Case and Conditionally Granting Relief from the Automatic Stay that was entered on January 27, 2017 (ECF # 139).[2]

BACKGROUND[3]

***79** The Debtor, Arm Ventures, LLC, filed its voluntary chapter 11 petition on October 4, 2016 (ECF # 1).[4] The Debtor owns commercial property at 753–755 Arthur Godfrey Rd., Miami Beach, Florida 33140 (the "Commercial Property"). Bonino Investment Group, LLC (trustee) owns 51.20% of the Commercial Property while the Debtor owns 48.8%. (ECF # 16). The Debtor claims that there are currently at least three entities leasing space at the Commercial Property.[5]

Ocean Bank holds a first mortgage that is secured by the building and land that make up the Commercial Property. (Ex. 2 p. 27–43). Ocean Bank and the Debtor have had a relationship for over a decade and Ocean Bank served as the primary lender and depository in regards to a series of United States Small Business Administration Loans ("SBA Loans") and non-SBA guaranteed loans made to the Debtor and its affiliates.[6] Additionally, Ocean Bank provided depository, loan, merchant, trust, and advisory services in regards to a pool of common collateral securing all of the SBA Loans involving ARM Ventures. (ECF # 81).

On April 20, 2010, the Debtor and its affiliates filed a state court lawsuit raising several lender liability claims against Ocean Bank.[7] On June 2, 2011, Ocean Bank filed two cases against the Debtor, its affiliates and the Guarantors to collect on some of the loans.[8] The three cases were eventually consolidated (the "Consolidated Lawsuit"). Although Ocean Bank extended numerous loans to the Debtor, the Consolidated Lawsuit only involved three loans—the Ocean Bank mortgage loan and two credit line loans. Those loans were all secured by the Commercial Property.

On August 16, 2012, the state court entered summary judgment in favor of Ocean ***80** Bank in the amount of $667,113.17 and ordered the sale of the Commercial Property. (Ex. 5). The state court judge also ruled that Ocean Bank was entitled to its attorneys' fees, but reserved jurisdiction to determine the amount of attorney's fees until the state court resolved all remaining issues in the Consolidated Lawsuit, including the Debtor's multiple counterclaims and defenses against Ocean Bank. The Commercial Property was redeemed prior to the foreclosure sale. Final summary judgment as to the remaining issues in the Consolidated Lawsuit was rendered in Ocean Bank's favor in April 2013 (Ex. 6) and affirmed by the Third District Court of Appeal. (Ex. 7).

Final judgment awarding Ocean Bank attorney fees in an amount of $841,099.03 was entered in the state court on February 19, 2015. (Ex. 8). The Debtor unsuccessfully appealed that judgment to the Third District Court of Appeal. (Ex. 9). The state court set a foreclosure sale in accordance with the February, 2015, judgment for May 31, 2016. (Ex. 10). The night before the sale, the Debtor removed the state court case to the United States District Court which removal cancelled the foreclosure sale. (Ex. 11). Soon thereafter, the case was remanded to the state court (Ex. 13) and a second foreclosure sale was set for July 28, 2016. (Ex. 15).

The night before the second foreclosure sale, the Debtor removed the case to federal court again. (Ex. 16). The foreclosure sale was, again, automatically cancelled. (Ex. 17). The District Court remanded the case to state court and in its remand order enjoined the Debtor from any further removal of the state court case. (Ex. 18).

The third foreclosure sale was set for October 5, 2016. (Ex. 21). In the days leading up to the third sale, the Debtor filed multiple emergency motions in the state court to delay the October 5 sale. (Exs. 22, 24, 25). The state court judge denied the motions and further ordered that "no further Motions to Cancel the Sale or Motions for Reconsideration will be entertained by the Court prior to tomorrow's sale date." (Ex. 27). The day before the third foreclosure sale, the Debtor filed this Chapter 11 case. (ECF # 1).

Shortly after the Debtor filed its petition, Ocean Bank filed this Motion arguing that the case should be dismissed for cause under 11 U.S.C. § 1112(b)(1) because the case was filed in bad faith. Ocean Bank argues that the Debtor's bad faith is evidenced by the Debtor's repeated attempts to stop the foreclosure sale by using procedures in both the state and federal court and using the bankruptcy court as a last resort when the prior procedures did not yield the Debtor's desired results. (ECF # 55).

At the hearing on the Motion, the Debtor acknowledged that the timing of the filing was unfortunate, but was really due to the fact that the Debtor was acting without advice of bankruptcy counsel when all those prior actions occurred. This argument is unpersuasive. The Debtor's principal is a lawyer, and also apparently the author of most, if not all, of the pleadings that were filed in the proceedings leading up to the case, and the author, or co-author of some of the pleadings that have been filed in this case.

Nonetheless, the Debtor urges that it filed bankruptcy with the intention of reorganizing its business, which business the Debtor alleges currently consists of leasing portions of the Commercial Property to its affiliates—Pharmaquick, LLC ("Pharmaquick"), Rosenbaum International Law Firm, P.A., and Bonino Investment Group, LLC; and adding another tenant—its affiliate Modern Pharmacy, LLC ("Modern Pharmacy").

***81** In support of its stated intent to reorganize, prior to the hearing on the Motion, the Debtor filed a Plan of Reorganization (the "Plan")(ECF # 76) and Disclosure Statement for Plan of Reorganization (the "Disclosure Statement")(ECF # 77), which Plan proposed, among other things, to rent space in the Commercial Property to a business that generates income from

medical marijuana.[9]

At the December 8 hearing Ocean Bank argued that, in addition to the *Phoenix Piccadilly* factors that it raised in the Motion, the Plan provided further support for dismissal since the Plan is based on income generated from marijuana. Ocean Bank pointed out that every court in the country that has dealt with a plan funded in whole or in part by the sale of marijuana has refused to confirm the plan. The Debtor responded that its proposed tenant, later revealed to be Modern Pharmacy, is going to apply for all the appropriate licenses under state and federal law necessary to sell medical marijuana, making its plan confirmable. At the hearing the Debtor also stated that Modern Pharmacy and Pharmaquick are already selling some kind of marijuana based drugs.[10] Ocean Bank observed that neither Modern Pharmacy nor Pharmaquick are currently listed as one of the seven licensed dispensing organizations approved in Florida to dispense low-THC cannabis and medical cannabis and, consequently, the sale of any marijuana based drug at the Commercial Property puts its collateral at risk.

At the conclusion of the hearing on December 8, I directed the Debtor to file an amended plan that either did not depend on marijuana as an income source, or better addressed several shortfalls with the plan structure. I also ordered the Debtor and Ocean Bank to file memoranda of law on the marijuana issue if the amended plan was going to rely on marijuana income. The Debtor then filed its First Amended Chapter 11 Plan of Reorganization (the "Amended Plan")(ECF # 97). The Amended Plan continues to rely on income generated from medical marijuana to make plan payments, including payments to Ocean Bank tied to the amount of income generated from the marijuana business.[11,12]

***82** Thus the Debtor and Ocean Bank filed supplemental briefing on the marijuana issue.

DISCUSSION

[1] [2]11 U.S.C. § 1112 lays out a non-exclusive list of reasons a court should consider dismissal of a chapter 11 case, including "for cause".[13] "For cause" includes the filing of a bankruptcy case in bad faith. *Albany Partners, Ltd. v. Westbrook (In re Albany Partners, Ltd.)*, 749 F.2d 670 (11th Cir. 1984). When determining whether a chapter 11 case should be dismissed as a bad faith filing, I must consider factors that evidence "an intent to abuse the judicial process and the purposes of the reorganization provisions". Thus I may consider factors such as "when there is no realistic possibility of an effective reorganization and it is evident that the debtor seeks merely to delay or frustrate the legitimate efforts of secured creditors to enforce their rights." *Id.* at 674.

[3]The Eleventh Circuit in *Phoenix Piccadilly, Ltd. v. Life Insurance Co. of Virginia (In re Phoenix Piccadilly, Ltd.),* 849 F.2d 1393 (11th Cir. 1988), listed a number of subjective factors in determining whether a dismissal for bad faith is appropriate. The factors include whether:

> (i) The Debtor only has one asset, ...;
>
> (ii) The Debtor has few unsecured creditors whose claims are small in relation to the claims of the Secured Creditors;
>
> (iii) The Debtor has few employees;
>
> (iv) The Property is the subject of a foreclosure action as a result of arrearages on the debt;
>
> ***83** (v) The Debtor's financial problems involve essentially a dispute between the Debtor and the Secured Creditors which can be resolved in the pending State Court Action; and
>
> (vi) The timing of the Debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the Debtor's secured creditors to enforce their rights.

Phoenix Piccadilly, 849 F.2d at 1384–95.

[4]The Debtor has only one asset[14]—the Commercial Property (and the leases relating to the Commercial Property) and no employees. The Debtor does have some other unsecured creditors; to date there are eight additional parties with undisputed non-insider non-priority unsecured claims totaling $631,987.00.[15] These claims are not insignificant in comparison to the $1,083,817.38 bifurcated claim filed by Ocean Bank[16]. However there is no doubt that the impending foreclosure sale, and the Debtor's frustration at the lack of success of its other litigation strategies to avoid a foreclosure of the Commercial Property is what precipitated the filing of this case.[17] Moreover, it is clear, based on all the events leading up to the filing, that this is essentially a dispute between Ocean Bank, the Debtor, and the various guarantors who are seeking to avoid liability.

In determining whether dismissal is appropriate due to lack of good faith I may also consider whether the Debtor has the ability to reorganize itself. *See In re North Redington Beach Associates, Ltd.*, 91 B.R. 166, 169 (Bankr. M.D. Fla. 1988). If after considering the economic realities of the Debtor's situation, I believe that there is no realistic chance for the Debtor to successfully reorganize, the case should be dismissed. *In re Albany Partners, Ltd.*, 749 F.2d at 674. *See also In re Natural Land Corp.,* 825 F.2d 296 (11th Cir. 1987). *Accord* 11 U.S.C. § 1112(b)(4)(J).

[5]The Debtor argues that it will be able to prove feasibility at confirmation. Modern Pharmacy, the proposed tenant, has apparently applied for both state and federal approval to cultivate and sell marijuana; however, Modern Pharmacy has yet to have its applications granted (ECF # 118).[18] Ocean Bank argues that the Plan ***84** is unconfirmable because it is highly unlikely that Modern Pharmacy would be able to get both state and federal approval to manufacture and sell medical marijuana—especially since, according to Ocean Bank, the Commercial Property is in close proximity to a school and to a synagogue (ECF # 117). However, it is not necessary for me to go into the details of where the Commercial Property is located, nor what is the status of the applications because the law is very clear—a bankruptcy plan that proposes to be funded through income generated by the sale of marijuana products cannot be confirmed unless the business generating the income is legal under both state law and federal law. Moreover, the conditions for feasibility are so speculative—both as to timing and authority—that any plan proposed by the Debtor based on the sale of marijuana is not confirmable, certainly not for the foreseeable future.

In *In re Rent–Rite Super Kegs W. Ltd.*, 484 B.R. 799, 809 (Bankr. D. Colo. 2012), the court ruled it would dismiss or convert the debtor's chapter 11 case because the debtor derived 25% of its revenues from leasing space to a tenant who was engaged in growing marijuana in a business legal under state law, but which business did not have DEA approval. The court noted that even if there were no good faith requirement in section 1129, the court could not confirm a plan that relied on income derived from a criminal activity.

In *In re Jerry L. Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015) the U.S. Trustee filed a motion to dismiss the chapter 13 case of a debtor whose income was derived partially from the cultivation and sale of marijuana to three patients to whom he also provided caregiver services. The debtor, who was licensed to grow and sell marijuana under state law grew the marijuana in his home. The debtor also had social security income which income he testified was the source of his chapter 13 payments to the chapter 13 trustee. The court held that, notwithstanding that the debtor's payments were from an "untainted" source, the debtor's continuing operation of a marijuana business, even if the income were segregated, would require the court, the trustee, and even the debtor (who under chapter 13 retains property of the estate)[19] to violate federal law, which they could not. Because the debtor had legitimate reasons to be in bankruptcy, the court said rather than dismiss the case the debtor could stop operating the marijuana business; otherwise, the case would have to be dismissed.

In *In re Arenas*, 535 B.R. 845 (10th Cir. BAP 2015), a chapter 7 case was filed by a state-licensed marijuana grower and his wife, whose income also included lease income from a state licensed marijuana dispensary. The U.S. Trustee filed a motion to dismiss the case on the basis that the chapter 7 trustee could not administer the assets—it would be a violation of federal law to which the trustee is subject. In response the debtors filed a motion to convert the case to a case under chapter 13 which motion the bankruptcy court denied. The bankruptcy court ruled that because the debtors' plan would have been funded from an activity illegal under Federal ***85** law—the growing and dispensing of medical marijuana—it was not a plan "proposed in good faith and not by any means forbidden by law" a confirmation requirement under 11 U.S.C. § 1325(a)(3). Since the debtors could not confirm a plan without the marijuana income, the debtors could not qualify to be debtors in a chapter 13

case. The court was also concerned because confirming the plan would require the Chapter 13 Trustee to violate federal criminal law to administer the plan payments. The bankruptcy court then granted the U.S. Trustee's motion to dismiss. The B.A.P. affirmed both the bankruptcy court's decision to deny the debtors' motion to convert their case to chapter 13 and to grant the U.S. Trustee's motion to dismiss. *Id.* at 855. *See also In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011) (holding that a chapter 13 plan was unconfirmable because it relied on a future change to Oregon medical marijuana law and it violated federal law).[20]

Even if the Debtor was otherwise of "pure mind and heart" when this case was filed, the very fact that the Amended Plan is based on income derived from the sale of marijuana can be deemed "bad faith". In *Arenas* the B.A.P. affirmed the bankruptcy court's finding that, notwithstanding that the debtors appeared "to be sincere and credible" and "their motives in seeking bankruptcy relief were not improper", nonetheless, "[i]t is objectively unreasonable for them to seek Chapter 13 relief whether their intentions are kindly or not" and, therefore, the B.A.P. upheld the bankruptcy court's finding of bad faith. 535 B.R. at 852–53. *Accord In re Jerry L. Johnson*, 532 B.R. at 53.

The Debtor argues that Modern Pharmacy should have a good chance of approval under the new Florida law because two of its principals already have licenses to handle Scheduled substances. However, in addition to the fact that whether Modern Pharmacy will be approved by the State of Florida to manufacture or sell medical marijuana is highly speculative (the rules and regulations haven't even been adopted yet), it is also irrelevant.

In each case where the court has denied confirmation or dismissed a case stemming from funding dependent in whole or in part from marijuana, the marijuana source of funding was legal under the relevant state law. The issue is whether Modern Pharmacy would be approved under *Federal* law to manufacture or sell marijuana. As of now, in all the years that marijuana has been explored as an option for treatment, only the University of Mississippi has ever received approval by the Federal government to grow, harvest, and store bulk marijuana and purified elements of marijuana for use by researchers. Thus it is highly unlikely, and at a minimum, at this juncture an extremely remote possibility, that the Debtor will receive approval from the Federal government.

In sum, in order to confirm the Amended Plan, the Debtor would face several hurdles including (a) proving by confirmation that Modern Pharmacy's business operation would be legal under both state and federal law and (b) proving that the income stream from the medical marijuana ***86** business would begin shortly after confirmation as opposed to years in the future.

It is not necessary to wait until a confirmation hearing. First, the Debtor cannot rid itself of the taint of the bad faith filing. *See In re Natural Land Corp.,* 825 F.2d at 296; *Albany Partners*, 749 F.2d at 670. Second, the Amended Plan is based on an enterprise illegal under Federal law, and therefore one that I cannot confirm because the Debtor cannot satisfy the requirements of 11 U.S.C. § 1129(a)(3). Third, the Amended Plan is highly speculative. As the United States Supreme Court held in a slightly different context, effective reorganization means "there must be 'a reasonable possibility of a successful reorganization within a reasonable time.' " *United Savings Ass'n of Texas v. Timbers of Inwood Forest*, 484 U.S. 365, 376, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988).

So, it is clear that this case is ripe for dismissal—both for subjective bad faith and objective bad faith; however, there is significant non-insider unsecured debt and I am not convinced at this juncture that dismissal is in the best interests of those creditors. It appears this case should remain in bankruptcy. So the motion to dismiss is DENIED.

[6]Ocean Bank alternatively argues that, at a minimum it is entitled to relief from stay. I agree. While I may have determined that, notwithstanding the multiple indicia of bad faith, dismissal is not immediately appropriate, I nonetheless find that those same factors warrant stay relief. *See Natural Land Corp.,* 825 F.2d at 296.

In addition, Ocean Bank, who has been receiving adequate protection payments[21], became concerned that it cannot accept those adequate protection payments, since, according to the Debtor, the payments were generated by the sale of marijuana based products. Ocean Bank expressed concern that the Property could be subject to forfeiture under 21 U.S.C. § 81(a)(7). However, apparently the sale of Marinol is legal. So, as it seems the Debtor's tenants are not selling medical marijuana, it appears Ocean Bank may accept the adequate protection payments without violating Federal law.[22]

Nonetheless, due to the Debtor's bad faith in filing this case and the Debtor's inability or unwillingness to propose a confirmable plan, Ocean Bank is granted relief from stay subject to the conditions set forth below.

CONCLUSION

Based on the foregoing it is ORDERED AS FOLLOWS:

1. Ocean Bank's Motion to Dismiss is DENIED. However, the Debtor will have fourteen (14) days from the date hereof to file a plan that does not depend on marijuana as a source of income. If the Debtor does not timely file an amended plan that complies with this directive the case shall be converted to a case under Chapter 7.[23]

***87** 2. Ocean Bank is granted relief from stay to continue with the foreclosure action. However, if the Debtor files a plan that does not depend on the sale of marijuana as an income source then the sale shall not be set for a date earlier than 75 days from the date hereof. If the Debtor's plan is confirmed before the expiration of the 75 days, then the sale shall be cancelled. If the Debtor does not file a plan within fourteen (14) days, then Ocean Bank may reset the sale for the earliest date allowed under state law.

All Citations

564 B.R. 77, 26 Fla. L. Weekly Fed. B 221

Footnotes

[1] I have considered the Motion; the Debtor's Objection to Ocean Bank's Motion for Entry of an Order (I) Dismissing the Debtor's Chapter 11 Case or, Alternatively, (II) Granting Relief from the Automatic Stay (the "Objection")(ECF # 72); the Debtor's Supplement to Debtor's Objection to Ocean Bank's Motion for Entry of an Order (I) Dismissing the Debtor's Chapter 11 Case or, Alternatively, (II) Granting Relief from the Automatic Stay (the "Debtor's Supplement")(ECF # 81); Ocean Bank's Supplemental Memorandum of Law in Further Support of its Motion to Dismiss ("Ocean Bank's Supplement")(ECF # 98); the Debtor's Response to Ocean Bank's Supplemental Memorandum of Law in Further Support of its Motion to Dismiss (the "Debtor's Response")(ECF # 108); and Ocean Bank's Reply to Debtor's Response to Ocean Bank's Supplemental Memorandum of Law in Further Support of its Motion to Dismiss ("Ocean Bank's Reply")(ECF # 117). I will not consider the Debtor's Second Supplement to Objection Ocean Bank's Motion for Entry of an Order (I) Dismissing the Debtor's Chapter 11 Case or, Alternatively, (II) Granting Relief from the Automatic Stay (ECF # 109) or any other pleadings relating to the Motion that were filed by the Debtor if the Debtor did not seek prior authority to file the additional documents.

[2] I originally delivered this ruling orally on January 23, 2017. Subsequent to that oral ruling (and the written order that followed), the Debtor has filed a Second Amended Chapter 11 Plan of Reorganization (ECF # 149) and a Second Amended Disclosure Statement (ECF # 150), pursuant to which the Debtor's reorganization is based on income that is not derived directly or indirectly from the sale of marijuana.

[3] The following are facts that are not disputed, except where noted. Although I have not conducted an evidentiary hearing on the motion to dismiss the parties have each filed multiple documents all of which I have considered, together with the applicable state and federal statutes and the Florida Department of Health's Office of Compassionate website at http://www.floridahealth.gov/programs-and-services /office-of-compassionate-use/. I have also reviewed the National Institute on Drug Abuse's website at https://www.drugabuse.gov/drugsabuse/marijuana/nidas-role-in-providing-marijuana-research and the Marinol website located at http://www.marinol.com. At the hearing at which I read portions of this ruling into the record, I told counsel that if they believed anything I had considered was inappropriate or that I needed to consider additional evidence that they needed to advise me at the end of the hearing. Other than the limited 2004 examination referenced in *infra* n. 11 and *n.* 22, the parties told me no additional evidence was necessary.

[4] The Debtor listed this case as a Single Asset Real Estate Case as defined by 11 U.S.C. § 101(51B).

[5] The Chapter 11 Case Management Summary (ECF # 16) indicates that there are currently three active leases—with Pharmaquick, LLC, Bonino Investment Group, LLC, and the Rosenbaum International Law firm, P.A., all insiders of the Debtor. A fourth lease, with Modern Pharmacy, LLC, has been mentioned at various hearings, but it now appears that Modern Pharmacy, LLC does not yet have a lease at the Commercial Property. Apparently no copies of the leases have been produced so the status of leases is not clear.

[6] Affiliates include Pharmaquick, LLC and Modern Pharmacy. LLC. The loans were guaranteed by Michael Rosenbaum, Berta Rosenbaum, Abraham Rosenbaum, Robert Novigrod and Kimberly Novigrod.

[7] *ARM Ventures, LLC, et al. v. Ocean Bank, et al.*, Case No. 10–23836 CA (02).

[8] In *Ocean Bank v. ARM Ventures, LLC, et al.*, Case No. 11–16966 CA(02), Ocean Bank sought enforcement of a promissory note, guarantees, and foreclosure of the pharmacy building owned by the Debtor that secured the ARM Ventures Loan. In *Ocean Bank v. Modern Pharmacy, LLC, et al.*, Case No. 11–16969 CA (02), Ocean Bank sought enforcement of the promissory notes relating to the Modern Pharmacy loan and the Pharmaquick loan.

[9] Subsequent to the hearing on the Motion, the Debtor filed a First Amended Plan (ECF # 97) and First Amended Disclosure Statement (ECF # 99) as well as a Supplement to Debtor's First Amended Disclosure Statement (ECF # 118).

[10] At the January 23 hearing at which I delivered the oral ruling that is memorialized in this Memorandum Opinion, Debtor's counsel confessed he did not actually know what was being sold at the Commercial Property. At a limited 2004 examination conducted after I delivered the oral ruling it was determined that Pharmaquick is selling Marinol, which is a synthetic analogue that may be legally sold pursuant to the Drug Enforcement Agency's (the "DEA") Rules if the pharmacy is licensed to prescribe Schedule III drugs. Florida has its own standards and schedules for classifying controlled substances, the Florida Schedules, which slightly differ from the Federal Schedules. Under the Florida Schedules, Marinol is classified as a Schedule III Drug. *See* Fla. Stat. § 893.03(2)–(3). According to the Debtor, both Modern Pharmacy and Pharmaquick are licensed to sell Schedule II and Schedule III substances (ECF # 108–2). An analogue is "a chemical compound that is structurally similar to another but differs slightly in composition (as in the replacement of one atom by an atom of a different element or in the presence of a particular functional group).". *See Analogue, The Merriam-Webster Dictionary New Edition* (2016).

[11] The Amended Plan provides that

> the payments to Ocean Bank to be made pursuant to section 5.3 of the Plan in addition to the Guaranteed Ocean Bank Plan Payments which shall equal 75% of the net income received by the Debtor from the lease of the second story to the Floor # 2 Leases: Compounding Pharmacy / CSA Marihuana Project which are projected to total $562,135.62 over the life of the Plan and which shall be paid to Ocean Bank on each anniversary of the Effective Date as an advanced payment towards the balloon payment that is due on the 60th month following the Effective Date.

[12] As noted, *see supra* n. 2, the Debtor has now filed a Second Amended Plan that complies with my oral ruling on January 23.

[13] "Cause" includes:

> **(A)** substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
> **(B)** gross mismanagement of the estate;
> **(C)** failure to maintain appropriate insurance that poses a risk to the estate or to the public;
> **(D)** unauthorized use of cash collateral substantially harmful to 1 or more creditors;
> **(E)** failure to comply with an order of the court;
> **(F)** unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;
> **(G)** failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;
> **(H)** failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
> **(I)** failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;
> **(J)** failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;

(K) failure to pay any fees or charges required under chapter 123 of title 28;
(L) revocation of an order of confirmation under section 1144;
(M) inability to effectuate substantial consummation of a confirmed plan;
(N) material default by the debtor with respect to a confirmed plan;
(O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and
(P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.
11 U.S.C. § 1112(b)(4).

14 After adoption of the single asset real estate provisions, the fact that a debtor only has one asset and few or no employees is not as significant when the debtor complies with the requirements of 11 U.S.C. § 362(d)(3) and timely files a plan or starts making the required payments.

15 The IRS has filed a $8,190.00 unsecured claim (Claim 1–2); however, on the Debtor's Schedules the IRS claim was listed as a priority claim under § 507(a)(8). It is not clear whether the unsecured claim is in addition to, or replaces, the scheduled claim.

16 Ocean Bank filed a claim with a secured amount of $905,942.88 and an unsecured amount of $177,874.50.

17 At the hearing, and in paragraph 26 of the Objection, the Debtor argued in support of its good faith intention to reorganize—"The possibility of the generation of the Marijuana Income only became a reality due to the results of the November 8, 2016 election...". However, this bankruptcy case was filed more than a month prior to the passage of the constitutional amendment.

18 Florida just recently adopted a constitutional amendment that legalizes medical marijuana. However, the state and local regulations and laws necessary to implement the change are still in the process of being drafted. Since 2014 under Fla. Stat. § 381.986, there has been a limited exception in Florida allowing for the use of medical cannabis if the patient's condition is terminal within one year, or the of low-THC cannabis for cancer, epilepsy, chronic seizures and chronic muscle spasms. Currently Florida has authorized seven dispensaries—Modern Pharmacy is not one of them. The constitutional amendment passed in 2016 expands the availability of medical marijuana to patients with one of ten (10) listed diseases or some "other debilitating medical conditions of the same kind or class as or comparable to those enumerated." However, while the Department of Health is promulgating rules dealing with the new amendment, Fla. Stat. § 381.986 is the only law authorizing the use of cannabis in Florida.

19 The court observed that a chapter 13 debtor, is, effectively, a debtor-in-possession—a bankruptcy fiduciary, and therefore cannot engage in activity illegal under federal law.

20 There are many more cases that have addressed this issue either directly or indirectly, *see e.g. In re Medpoint Mgt., LLC.*, 528 B.R. 178 (Bankr. D. Ariz. 2015), *vacated in part*, 2016 WL 3251581 (9th Cir. BAP 2016)(petitioning creditors who filed an involuntary petition against a company with whom they were involved in the (legal under state law) medical marijuana business, acted with unclean hands because they were engaged in activity illegal under federal law). The holding of each is the same—the cultivation and sale of marijuana is illegal under federal law and therefore the federal law and the federal courts are not available to any person engaged in that business.

21 The Debtor filed a Motion for Authorization to Make Monthly Adequate Protection Payments to Ocean Bank (ECF # 25). On November 23, 2016 the Court entered an Interim Order Granting Debtor's Motion for Payment of Adequate Protection to Ocean Bank (ECF # 61).

22 Subsequent to my issuing my oral ruling, Ocean Bank conducted a limited 2004 examination and confirmed that the Debtor's income was not derived either directly or indirectly from the sale or production of marijuana.

23 The Debtor has timely filed a Second Amended Plan. *See supra* n. 2.

End of Document

532 B.R. 53
United States Bankruptcy Court,
W.D. Michigan.

In re: Jerry L. Johnson, Debtor.

Case No. DG 15–02000
|
Signed June 16, 2015

Synopsis

Background: United States Trustee filed motion to dismiss Chapter 13 case of debtor, who had a medical marijuana business under the Michigan Medical Marihuana Act (MMMA), asserting that the bankruptcy court should not enforce the protections of the Bankruptcy Code to aid violations of the federal Controlled Substances Act (CSA).

[Holding:] The Bankruptcy Court, Scott W. Dales, Chief Judge, held that court would enjoin debtor from conducting his medical marijuana business and violating the CSA, rather than dismiss case.

Ordered accordingly.

West Headnotes (1)

[1] **Bankruptcy** Injunction or stay of other proceedings
Bankruptcy Grounds or cause in general; bad faith

Bankruptcy court would enjoin Chapter 13 debtor, who had a medical marijuana business under the Michigan Medical Marihuana Act (MMMA), from conducting his business and violating the Controlled Substances Act (CSA) while his case was pending, rather than dismiss his case; debtor could not conduct an enterprise that violated federal criminal law while enjoying the federal benefits the Bankruptcy Code afforded him, but at the same time, debtor had filed his case in good faith, and he was in dire need of bankruptcy relief and the court's assistance. Controlled Substances Act, § 101 et seq., 21 U.S.C.A. § 801 et seq.; Mich. Comp. Laws Ann. § 333.26421 et seq.

3 Cases that cite this headnote

Attorneys and Law Firms

Roger G. Cotner, Cotner Law Offices, Grand Haven, MI, for Debtor.

***54** *MEMORANDUM OF DECISION AND ORDER*

PRESENT: HONORABLE SCOTT W. DALES, Chief United States Bankruptcy Judge

I. INTRODUCTION

The country's relationship with marijuana is changing, slowly, and one person's pusher is another's caregiver. Jerry L. Johnson (the "Debtor"), a licensed "caregiver" and marijuana grower under the Michigan Medical Marihuana Act[1] filed for relief under chapter 13 after falling behind on his house payments, his utility payments, and at least one payment on his truck. His case presents the question of whether his business, legitimate under state law but criminal under federal law, precludes the court from granting him the relief available under the United States Bankruptcy Code.

The United States Trustee filed a motion to dismiss (the "Motion," DN 37), arguing that "the debtor appears to be engaged in the marijuana industry and the Court should not enforce the protections of the Bankruptcy Code to aid violations of the federal Controlled Substances Act." *See* Motion at p. 1.

The court expedited its consideration of the Motion, and held an evidentiary hearing on June 15, 2015, in Grand Rapids, Michigan, at which the Debtor, the United States Trustee, and the standing chapter 13 trustee, Brett N. Rodgers, all appeared through counsel.[2]

After listening to the Debtor's testimony and the arguments of counsel, the court took the matter under advisement. The following constitutes the court's findings of fact and conclusions of law in accordance with Fed. R. Civ. P. 52, applicable in this contested matter pursuant to Fed. R. Bankr. P. 9014(c) and 7052.

II. JURISDICTION

The United States District Court has jurisdiction over the Debtor's chapter 13 case pursuant to 28 U.S.C. § 1334(a), but has referred the case and all related proceedings to the United States Bankruptcy Court pursuant to 28 U.S.C. § 157(a) and W.D. Mich. LCivR 83.2(a). The Motion, which seeks dismissal, is a contested matter raising the question of the Debtor's eligibility for relief under title 11, and therefore lies at the core of the Bankruptcy Court's authority. 28 U.S.C. § 157(b)(2)(A) & (O). The court, therefore, has authority to enter a final order in this contested matter.

III. ANALYSIS

1. *The Debtor's Testimony*

The Debtor testified credibly under oath that he is a sixty-six year old man who lives in a house he has owned for approximately nine years in Spring Lake, Michigan (the "Residence"). The Residence serves as collateral for a mortgage loan, and because the loan is in default,[3] the ***55** Debtor's lender scheduled a foreclosure sale for April 2, 2015. To prevent the foreclosure, the Debtor filed his bankruptcy petition on April 1, 2015.

The Debtor also testified that he fell behind on his payments for electric service at the Residence, which prompted the utility company to threaten termination of the service. In addition, he was slightly late in making truck payments, and worried that his lender might repossess the vehicle.

As he evidently did during the meeting of creditors, the Debtor testified that his income consists of approximately $1,203.00 per month from the Social Security Administration, which he became entitled to receive four years ago, and approximately $1,000.00 per month that he derives from cultivating and selling marijuana to three patients and a regulated dispensary, pursuant to the MMMA. According to his testimony, he is a registered "caregiver" under the MMMA. His identification card, admitted as Exhibit A, shows that he has a "Registry Number" under the Michigan Medical Marihuana Program issued by the Michigan Department of Licensing and Regulatory Affairs.

The Debtor contended, without controversy, that his marijuana-related business activities—cultivation, possession, and sale—all comply with the MMMA.[4] He stated that the amount of marijuana he possesses from time to time is within the legal limits (*i.e.,* 2 ½ ounces and 12 plants per patient), and that he has never sold marijuana to minors or outside Michigan. As for his personal use, he is eligible to use marijuana under the MMMA due to certain medical conditions, but he refrains from using it because he does not like feeling "stoned."

The Debtor further testified that he grows the marijuana plants in the basement of his Residence, where he still lives because the foreclosure sale was stayed by the filing of his chapter 13 petition. The court infers from the Debtor's testimony that he uses his truck to transport the marijuana either to his "patients" or to the dispensary where he sells any surplus above the patients' requirements. The Residence, the truck, all horticultural items, including fertilizer and any growing lights that the Debtor uses in connection with his marijuana business, are included within the property of his bankruptcy estate pursuant to § 541(a) or § 1306 (to the extent he acquired any such property post-petition). And, because the Debtor filed for relief under chapter 13, all post-petition earnings from his marijuana business and his Social Security income are also included within the bankruptcy estate under § 1306(a), although the Social Security benefits may not be available to pay claims without the Debtor's consent.

The Debtor said he filed for protection under the Bankruptcy Code to save his Residence, prevent the termination of utility services, and avoid repossession of his truck—in his words, to avoid turning his world "upside down." The court credits his report, and assumes that he shares this motivation with most other debtors on the court's consumer docket. Indeed, except for the fact that he derives almost half of his income from the cultivation of marijuana, the Debtor has much in common with many older debtors in our District who have health problems and difficulty making ends meet.

The Debtor testified that he has already made two payments to his chapter 13 trustee, ***56** and that the source of those payments was his Social Security income, rather than income from his marijuana business. He said that his monthly Social Security benefit of $1,203.00 is directly deposited into one of his two bank accounts on the third day of each month, and that he made his pre-confirmation plan payments on the fourth or fifth day of May and June. According to the Debtor's proposed plan, his monthly plan payment is $948.00, well below his monthly Social Security benefit. Notwithstanding the possibility that proceeds of the Debtor's marijuana business were commingled with the Social Security benefits, the court finds by a preponderance of the evidence that the Debtor used his retirement benefits to fund his plan payments in May and June.

2. *Legal Analysis*

The parties agree, as they must, that Michigan law and federal law diverge in the treatment of marijuana, at least with respect to so-called "medical marijuana." Assuming compliance with the MMMA, a person may cultivate, possess, and even distribute some amount of the plant or its products without offending the laws of Michigan. *See generally* M.C.L. § 333.26421 *et seq.* Federal law, in contrast, criminalizes possession and distribution of marijuana—the very activities that are central to the Debtor's business model—with exceptions only for limited, federally approved research activities. *See* 21 U.S.C. § 801 *et seq.* (the Controlled Substances Act or "CSA"); *see also United States v. Hicks,* 722 F.Supp.2d 829 (E.D.Mich.2010). The Debtor's marijuana business, though presumably authorized as a matter of state law, violates federal criminal law. This is true as a legislative matter, irrespective of any statements that the United States Attorney General or any deputy may have made about the exercise of prosecutorial discretion as an executive matter.[5]

By sanitizing the plan payments (*i.e.,* segregating marijuana proceeds from Social Security benefits) and by distinguishing the case law upon which the United States Trustee relies,[6] the Debtor implicitly concedes the impropriety of requiring the Standing Trustee to hold the proceeds of the Debtor's criminal activity and to use those funds to pay claims under a court-approved plan. Indeed, the court will not lend its office to such an arrangement for several reasons.

First, federal judicial officers take an oath to uphold federal law, and countenancing the Debtor's continued operation of his marijuana business under the court's protection is hardly consistent with that oath. Even if the Debtor scrupulously segregates the proceeds of his criminal activity from his Social Security benefits in the future, money is fungible and the arrangement would invariably taint the court and the Standing Trustee. In other ***57** words, irrespective of any segregation of funds, the court and the Standing Trustee carrying out their respective statutory duties will inevitably support the Debtor's criminal enterprise. The automatic stay preserves the Debtor's title and possession to the Residence where he cultivates the marijuana, the horticultural equipment and fertilizers he uses to grow it, and even the truck in which he transports it. To the extent that the Debtor is "engaged in business" within the meaning of § 1304(a), which seems likely, his continued operation of the business depends upon the court's acquiescence. *See* 11 U.S.C. § 1304(b). The Debtor's financial life is inextricably bound up with his federal criminal activity through the chapter 13 plan, even if he segregates proceeds of that activity. The two aspects of the Debtor's life cannot be hermetically sealed from each other, and the pervasive benefits of bankruptcy will invariably advance both.

Second, as a statutory matter, the same reasons that preclude the Standing Trustee from holding contraband or using proceeds or instrumentalities of federal criminal activity apply to a debtor in possession. *Cf.* 28 U.S.C. § 959(b); *In re Commonwealth Oil Ref. Co.,* 58 B.R. 608 (Bankr.W.D.Tex.1985) (construing 28 U.S.C. § 959(b) as requiring trustees and debtors in possession to comply with federal *and* state law). It goes without saying that a bankruptcy trustee must abide by federal law, including federal criminal law, and the Debtor seems to concede the point. It requires no stretch of the imagination to extend that requirement to bankruptcy debtors who remain in possession of estate property,[7] and who use that property or conduct their business under the court's aegis. The court reads §§ 1303 and 1304 as bestowing on a chapter 13 debtor the authority to use estate property that a trustee would have under various subsections of § 363, subject to the same limitations that would otherwise bind a trustee. *See* 11 U.S.C. §§ 1303 and 1304. If the Standing Trustee is precluded by federal criminal law from using estate property in a certain manner, the Debtor as debtor in possession is similarly precluded.

The United States Trustee contends that the Debtor's post-petition medical marijuana business violates federal law and renders the Debtor ineligible for relief under the Bankruptcy Code. The court accepts the United States Trustee's premise, but the conclusion that dismissal is required does not necessarily follow.

The Debtor's business is patently incompatible with a bankruptcy proceeding, but his financial circumstances are not. In other words, if the Debtor were not engaged in post-petition criminal activity, there would likely be no controversy about his eligibility for relief under chapter 13.[8] The problem, of course, is that he derives nearly half of his income from activity that Congress forbids as criminal. The Debtor, it seems, must choose between conducting his medical marijuana business and pursuing ***58** relief under the Bankruptcy Code. The court has ample authority to require him to make that choice, and given his obvious financial distress, the court concludes that this approach is preferable to dismissal.

Although neither party cited the statute, the Debtor's testimony that he is running a sole-proprietorship from his Residence

prompts the court to consider the role that § 1304 plays in this proceeding. The Debtor is self-employed, and appears to be incurring trade debt in connection with the business, at least in the form of debts for electricity.[9]

He is arguably "engaged in business" within the meaning of § 1304 which provides in relevant part as follows:

> *Unless the court orders otherwise,* a debtor engaged in business may operate the business of the debtor and, *subject to any limitations on a trustee under sections 363(c) and 364 of this title and to such limitations or conditions as the court prescribes,* shall have, exclusive of the trustee, the rights and powers of the trustee under such sections.

11 U.S.C. § 1304(b) (emphasis added). Based upon the Debtor's testimony, the court finds that he is using estate property (including the Residence, his truck, and all horticultural equipment, fertilizer and other supplies) in connection with his marijuana growing business, assuming the term "business" encompasses commercial activity that is legitimate under state law, but not federal. If so, §§ 363(c) and 1304 authorizes chapter 13 debtors to use estate property to conduct business, "[u]nless the court orders otherwise." *See* 11 U.S.C. §§ 363(c) and 1304. Moreover, to the extent that the Debtor is not "engaged in business" within the meaning of § 1304, he may only use estate property with the court's permission under § 363(b), which the court would obviously withhold for all the reasons set forth above.

For slightly different reasons, the court could prohibit or condition the use of property that serves as collateral—here the Residence and truck—to provide adequate protection. *See* 11 U.S.C. § 363(e) (on request of creditor court may, at any time, prohibit or condition use of property to provide adequate protection); *id.* § 105(a) (Bankruptcy Code shall not be construed to prevent court from taking action *sua sponte*). The Debtor's current use of these two items of property in connection with the violation of the CSA puts the property (and the related secured creditors) at risk of forfeiture. *See, e.g.,* 21 U.S.C. §§ 856 & 881. The court has the authority to mitigate that risk.

Under these unusual circumstances, the Debtor must make a choice. He can either continue his medical marijuana business or avail himself of the benefits of the Bankruptcy Code, but not both. If he chooses the latter, the court will require him to discontinue growing, selling and transferring marijuana to any and all patients and dispensaries immediately and to cease using property of the estate to further this activity.

With respect to the marijuana plants themselves (and any products or inventory derived therefrom) included within the estate pursuant to §§ 541(a) and 1306(a), because their contraband nature renders them of inconsequential value and burdensome to the estate as a matter of law, the court will order abandonment of the marijuana plants and any products or inventory ***59** derived therefrom without further notice or opportunity for hearing. *See* 11 U.S.C. §§ 102(1) and 554. Furthermore, the court will order the Debtor to destroy the marijuana plants and any product or inventory derived therefrom forthwith. Eliminating the contraband from the estate by way of immediate abandonment, and ordering its destruction as a condition of the Debtor's eligibility to proceed further, will remove the shadow that the contraband casts on this proceeding, the Standing Trustee, and the court.

IV. CONCLUSION

In the court's view, the Debtor cannot conduct an enterprise that admittedly violates federal criminal law while enjoying the federal benefits the Bankruptcy Code affords him. "There is no constitutional right to obtain a discharge of one's debts in bankruptcy," *United States v. Kras,* 409 U.S. 434, 446, 93 S.Ct. 631, 34 L.Ed.2d 626 (1973), and it is not asking too much of debtors to obey federal laws, including criminal laws, as a condition of obtaining relief under the Bankruptcy Code.

At the same time, the Debtor filed his case in good faith, and it is quite obvious from his credible testimony that he is in dire need of bankruptcy relief and the court's assistance. The court is willing to assist, provided, however, the Debtor discontinues

the medical marijuana business.

To balance the court's (and the Debtor's) obligations under federal law, including federal criminal law, the Debtor's legitimate need for relief under chapter 13, and Michigan's policy choices reflected in the MMMA, the court will refrain from dismissing the Debtor's case at this time, but will enjoin him from conducting his medical marijuana business (and violating the CSA), while his case is pending.

If, however, the Debtor prefers to continue his illicit business activity (albeit subject to the possibility of federal criminal prosecution), he need only file a motion to dismiss this case under § 1307(b), and the court's injunction will cease upon dismissal.

To ensure compliance with the injunction, the court will hold an evidentiary hearing in the next several weeks, at a date to be determined, to hear from the Debtor, under oath and subject to cross-examination, about the steps he has taken in response to this Order. If the court concludes that the Debtor has violated the court's injunction, it will almost certainly dismiss the case at that time.

NOW, THEREFORE, IT IS HEREBY ORDERED as follows:

(1) the Debtor shall forthwith cease using any property of the estate, including but not limited to the Residence, the truck, the horticultural equipment, the fertilizer or any other property, directly or indirectly, in connection with the possession, cultivation, sale, distribution, or other transfer of marijuana, irrespective of any regulation under, or compliance with, the MMMA;

(2) any and all marijuana plants included within the estate under §§ 541 or 1306 are hereby ABANDONED, effective immediately, and therefore no longer included within the estate;

(3) the Debtor shall forthwith destroy any marijuana plants, by-products or other substances derived from the marijuana plants, which are in his possession, custody, or control, as a condition of continuing as a debtor in bankruptcy;

(4) unless the case is sooner dismissed, the Clerk shall schedule an evidentiary hearing to consider the Debtor's compliance with this Order, to be held not later than 14 days after entry of this Order; and

***60** (5) the United States Trustee's Motion (DN 37) is DENIED without prejudice to renewal, including by oral motion at the evidentiary hearing contemplated in this Order.

IT IS FURTHER ORDERED that the Clerk shall serve a copy of this Memorandum of Decision and Order upon Jerry L. Johnson, Roger G. Cotner, Esq., Brett N. Rodgers, Esq., chapter 13 trustee, Michelle Wilson, Esq., and the United States Trustee, pursuant to Fed. R. Bankr. P. 9022 and LBR 5005–4.

IT IS SO ORDERED.

All Citations

532 B.R. 53

Footnotes

[1] M.C.L. § 333.26421 *et seq.* (hereinafter the "MMMA").

[2] The chapter 13 standing trustee, Brett N. Rodgers (the "Standing Trustee"), filed a similar motion, which the court scheduled for hearing at a later date. During the June 15, 2015 hearing, the Standing Trustee largely deferred to the United States Trustee

regarding the Motion.

[3] According to the Debtor's plan documents, which the court takes judicial notice of pursuant to Fed. R. Evid. 201, the Debtor is behind on his payments to "America's Servicing" in the amount of approximately $10,000.00. Through this proceeding he hopes to cure the default with funds from a program known as "Step Forward Michigan" operated through the Michigan State Housing Development Authority.

[4] Nothing in this decision should be construed as finding that the Debtor's activities are legal as a matter of state law. Rather, like the United States Trustee, the court simply assumes the legality for purposes of argument.

[5] The Debtor attaches to his responding brief two memoranda from high-ranking officials at the United States Department of Justice offering guidance to federal prosecutors regarding enforcement of the CSA in states, like Michigan, that have decriminalized marijuana under state law. Although the memoranda sensibly encourage prosecutors to think twice before suing cancer patients in states that permit medical use of marijuana, both clearly state that "Congress has determined that marijuana is a dangerous drug, and the illegal distribution and sale of marijuana is a serious crime ... " *See* Memorandum from Deputy Attorney General David W. Ogden to Selected United States Attorneys dated Oct. 19, 2009 (DN 56–2) and Memorandum from Deputy Attorney General James M. Cole to United States Attorneys dated June 29, 2011 (DN 56–3).

[6] *See, e.g., In re Rent–Rite Super Kegs West, Ltd.,* 484 B.R. 799, 805 (Bankr.D.Colo.2012).

[7] 11 U.S.C. § 1306(b).

[8] The Debtor earnestly testified about his genuine financial problems, and about his efforts to pursue a business that his state regards as legitimate. Michigan's decriminalization and regulation of medical marijuana tends to undercut any finding of bad faith premised on the nature of his business. The Debtor, on the verge of foreclosure and facing the shutoff of utility service, is clearly in financial distress. He has health problems and, at sixty-six years of age, has limited earning potential. He apparently gave candid testimony during the meeting of creditors about the nature of his business, and continued his candor before the court during the hearing on June 15, 2015. He appears to be an honest and unfortunate debtor. Under the circumstances, the court does not regard this case as having been filed in bad faith, notwithstanding the CSA.

[9] The court infers that the sizeable utility debts listed in the Debtor's schedules are attributable in part to the horticultural lighting almost certainly required for growing marijuana plants in one's basement. In the context of this Debtor's business, therefore, the utility debt qualifies as "trade debt" as used in § 1304(a).

End of Document

AMERICAN BANKRUPTCY INSTITUTE

Marijuana Businesses Barred from the Bankruptcy Courts: But How Far Will the Bar Extend?

As more and more states pass laws allowing the sale of marijuana, whether for medicinal or recreational purposes, investors will try to claim their share of what is certainly going to be a lucrative market. However, even in a growing market, private enterprises fail or need restructuring. This raises the question of whether distressed marijuana businesses, and those doing business with marijuana businesses, can seek relief under the Bankruptcy Code.

Since the George W. Bush Administration, the Office of the United States Trustee (the "UST") has taken the position that marijuana businesses cannot seek bankruptcy relief. This position was reaffirmed in Congressional testimony given in June 2017 by Clifford White, the Director of the Executive Office for U.S. Trustees, and more recently in an article written by Mr. White and John Sheahan, a trial attorney for the UST, which was published in the December 2017 edition of the American Bankruptcy Institute Journal.

Underlying the UST's position is the primacy of the federal Controlled Substances Act, 21 U.S.C. §§ 801, *et seq.* (the "CSA") over conflicting state laws. According to the UST, the CSA raises two impediments in any marijuana business bankruptcy. First, "the bankruptcy system may not be used as an instrument in the ongoing commission of a crime, and reorganization plans that permit or require continued illegal activity may not be confirmed." Second, "trustees and other estate fiduciaries should not be required to administer assets if doing so would cause them to violate federal criminal law." Based upon these principles, the UST takes the position that it will move to dismiss any bankruptcy case filed by a marijuana business. In fact, bankruptcy courts have already rejected bankruptcy cases filed by businesses engaged in the legal cultivation and sale of marijuana or by their principals who would use marijuana business income to fund their individual plans. *See In re McGinnis*, 453 B.R. 770 (Bankr. D. Or. 2011) (court refused to confirm a Chapter 13 plan which would be funded by income generated by cultivating and selling marijuana); *In re Johnson*, 532 B.R. 53 (Bankr. W.D. Mich. 2015) (court held that Chapter 13 case would be dismissed unless the debtor stopped operating marijuana business, even though only part of the debtor's income came from cultivating and selling marijuana); *In re Mother Earth's Alternative Healing Coop., Inc.*, Case No. 12-10223, Doc. No. 43 (Bankr. S.D. Cal. Oct. 23, 2012) (court dismissed Chapter 11 case filed by medical marijuana dispensary on the basis that the debtor was violating the CSA).

The UST's position is not surprising when it is applied to companies directly involved in the cultivation and distribution of marijuana. However, the position becomes less tenable when it is applied to businesses that are ancillary to growers and distributors. For instance, under the CSA there is no distinction between a seller or grower of marijuana and those more downstream, such as landlords renting space to the seller or grower. *See* 21 U.S.C. § 856 (making it illegal to "manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance."). The UST will treat the landlord the same as the dispensary itself since both are acting in violation of the CSA.

This is perhaps the most troublesome aspect of the UST's position. For instance, take the example of a commercial landlord who owns fifty commercial properties that it leases to various businesses. If one of those businesses was a medical marijuana dispensary opened in a state that permits medical marijuana, the landlord would not be able to access the bankruptcy courts simply because of its one dispensary tenant. This is exactly the result that has been reached in bankruptcy cases filed by landlords who leased properties to tenants legally engaged in the marijuana business. *See In re Rent-Rite Super Kegs*, 484 B.R. 799 (Bankr. D. Colo. 2012) (court dismissed Chapter 11 case filed by landlord who derived 25% of its revenue from marijuana business tenant); *In re Arm Ventures, LLC*, 564 B.R. 77 (Bankr. S.D. Fla. 2017) (court rejected Chapter 11 plan that was funded by income generated by rental payments received from marijuana dispensary, holding that the funds supporting a plan had to be legal under both state and federal law). The reasoning employed by the courts in dismissing the cases, namely that the landlords cannot fund a plan based upon property used in violation of the CSA or proceeds generated by the property, could even apply as you get further down the line from the actual marijuana business itself and could potentially impact any entity that derived income through business transactions with marijuana companies, no matter how small or insignificant that business relationship may be.

It remains to be seen how far the UST intends to push its position. Will the UST move to dismiss a bankruptcy case filed by a landlord who drives only an insignificant portion of its revenues from a legal marijuana business? Will a company that sells fertilizer to a legal marijuana grower be permitted to access the bankruptcy courts? Or will the UST seek to bar these companies from the bankruptcy court? The answers to these questions is uncertain. What is certain, however, is (a) that the UST will continue to oppose bankruptcy relief for marijuana businesses, and those

related to the marijuana businesses, until the CSA is amended to permit the cultivation and distribution of marijuana, and (b) that state law permitting marijuana-based businesses will have no effect on questions of bankruptcy eligibility.

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4. JUDGE CHARLES NOVACK

Topic: The recent Ninth Circuit case of *In re Taggart*, 888 F.3d 438 (9th Cir. 2018), which discusses when a discharge injunction violation warrants a contempt finding.

888 F.3d 438
United States Court of Appeals, Ninth Circuit.

IN RE Bradley Weston TAGGART, Debtor,
Shelley A. Lorenzen, Executor of Estate of Stuart Brown; Terry W. Emmert; Keith Jehnke; Sherwood Park Business Center, LLC, Appellants,
v.
Bradley Weston Taggart, Appellee.
In re Bradley Weston Taggart, Debtor,
Bradley Weston Taggart, Appellant,
v.
Shelley A. Lorenzen, Executor of Estate of Stuart Brown; Terry W. Emmert; Keith Jehnke; Sherwood Park Business Center, LLC, Appellees.
In re Bradley Weston Taggart, Debtor,
Bradley Weston Taggart, Appellant,
v.
Terry W. Emmert; Keith Jehnke; Sherwood Park Business Center, LLC; Shelley A. Lorenzen, Executor of Estate of Stuart Brown, Appellees.
In re Bradley Weston Taggart, Debtor,
Shelley A. Lorenzen, Executor of the Estate of Stuart Brown, Appellant,
v.
Bradley Weston Taggart, Appellee.
In re Bradley Weston Taggart, Debtor,
Terry W. Emmert; Keith Jehnke; Sherwood Park Business Center, LLC, Appellants,
v.
Bradley Weston Taggart, Appellee.
In re Bradley Weston Taggart, Debtor,
Shelley A. Lorenzen, Executor of Estate of Stuart Brown, Appellant,
v.
Bradley Weston Taggart, Appellee.
In re Bradley Weston Taggart, Debtor,
Terry W. Emmert; Keith Jehnke; Sherwood Park Business Center, LLC, Appellants,
v.
Bradley Weston Taggart, Appellee.

No. 16-35402, No. 16-60032, No. 16-60033, No. 16-60039, No. 16-60040, No. 16-60042, No. 16-60043
|
Argued and Submitted October 3, 2017, Portland, Oregon
|
Filed April 23, 2018

Synopsis

Background: Former Chapter 7 debtor filed motion to hold attorney and his clients in contempt for willfully violating discharge injunction. The United States Bankruptcy Court for the District of Oregon, Randall L. Dunn, J., 2011 WL 6140521, denied motion, and also denied subsequent motion for reconsideration, 2012 WL 280726. Debtor appealed. The District Court, Mosman, J., 2012 WL 3241758, reversed. On remand, the Bankruptcy Court, Dunn, J., 522 B.R. 627, entered order awarding contempt sanctions. Appeal was taken. The United States Bankruptcy Appellate Panel of the Ninth Circuit, Jury, J., 548 B.R. 275, reversed and vacated. Both sides appealed.

[Holding:] The Court of Appeals, Bea, Circuit Judge, held that prepetition creditors' good faith belief that discharge injunction did not prevent them from seeking attorney fee award against debtor for fees that they incurred postdischarge, because debtor had allegedly "returned to the fray" in continuing to litigate with creditors, precluded award of contempt sanctions against creditors for violating discharge injunction, regardless of whether creditors' belief was reasonable one.

Affirmed.

West Headnotes (10)

[1] **Bankruptcy** Post-petition debts or liabilities

If debtor "returns to the fray" by engaging in post-bankruptcy litigation with prepetition creditor, creditor may seek attorneys' fee award without violating discharge injunction, as long as the new litigation was not within fair contemplation of parties prior to debtor's bankruptcy filing. 11 U.S.C.A. § 524(a)(2).

Cases that cite this headnote

[2] **Bankruptcy** Violation of discharge order

Bankruptcy court may enforce discharge injunction by holding in contempt a party who knowingly violates debtor's discharge. 11 U.S.C.A. § 524(a)(2).

Cases that cite this headnote

[3] **Bankruptcy** Conclusions of law; de novo review

Court of Appeals reviews decisions of the Bankruptcy Appellate Panel de novo.

Cases that cite this headnote

[4] **Bankruptcy** Discretion

Bankruptcy court's decision to impose contempt sanctions is reviewed for abuse of discretion.

Cases that cite this headnote

[5] **Bankruptcy** Discretion

Bankruptcy court abuses its discretion if its decision is based on incorrect legal rule, or if its application of the correct legal standard was (1) illogical, (2) implausible, or (3) without support in inferences that may be drawn from facts in record.

Cases that cite this headnote

[6] **Contempt** Disobedience to Mandate, Order, or Judgment
Contempt Presumptions and burden of proof
Contempt Weight and sufficiency

On motion to hold party in contempt, movant bears initial burden of proving, by clear and convincing evidence, that contemnors violated specific and definite order of court, whereupon the burden shifts to contemnor to demonstrate why he was unable to comply.

Cases that cite this headnote

[7] **Bankruptcy** Violation of discharge order

To obtain contempt sanctions against creditor for violating discharge injunction, movant must prove that creditor (1) knew the discharge injunction was applicable, and (2) intended the actions which violated the injunction. 11 U.S.C.A. § 524(a)(2).

2 Cases that cite this headnote

[8] **Bankruptcy** Violation of discharge order

In order for creditor to be held in contempt for violating discharge injunction with knowledge that it was applicable, creditor's knowledge of applicability of injunction must be proven as matter of fact and may not be inferred simply because creditor knew of bankruptcy proceeding. 11 U.S.C.A. § 524(a)(2).

Cases that cite this headnote

[9] **Bankruptcy** Violation of discharge order

Creditor's good faith belief that discharge injunction does not apply to creditor's claim precludes a finding of contempt for creditor's violation of discharge injunction, even if the creditor's belief is unreasonable. 11 U.S.C.A. § 524(a)(2).

2 Cases that cite this headnote

[10] **Bankruptcy** Violation of discharge order

Prepetition creditors' good faith belief that discharge injunction did not prevent them from seeking attorney fee award against debtor for fees that they incurred postdischarge, because debtor had allegedly "returned to the fray" in continuing to litigate with creditors, precluded award of contempt sanctions against creditors for violating discharge injunction after it was ultimately determined that debtor's conduct did not rise to level of "returning to the fray," regardless of whether creditors' belief was reasonable one. 11 U.S.C.A. § 524(a)(2).

2 Cases that cite this headnote

***440** Appeal from the United States District Court for the District of Oregon Michael W. Mosman, Chief District Judge, Presiding, D.C. No. 3:12-cv-00236-MO

Appeal from the Ninth Circuit Bankruptcy Appellate Panel Kirscher, Jury, and Faris, Bankruptcy Judges, Presiding, BAP No. 15-1158, BAP No. 15-1119

Attorneys and Law Firms

John Martin Berman (argued) and Damon J. Petticord, Tigard, Oregon, for Bradley Weston Taggart.

Janet M. Schroer (argued), Hart Wagner LLP, Portland, Oregon; James Ray Streinz, Streinz Law Office, Portland, Oregon, for Shelley Lorenzen.

Hollis Keith McMilan (argued), Hollis K. McMilan P.C., Portland, Oregon, for Terry W. Emmert, Keith Jehnke, and Sherwood Park Business Center LLC.

Before: Edward Leavy, Richard A. Paez, and Carlos T. Bea, Circuit Judges.

OPINION

BEA, Circuit Judge:

***439** This case arises out of a complex set of bankruptcy proceedings. Appellant Bradley Taggart was a real estate developer who owned a 25% interest in Sherwood Park Business Center, LLC ("SPBC"). Appellees and Cross-Appellants Terry Emmert and Keith Jehnke also each owned a 25% interest in SPBC. In 2007, Taggart allegedly transferred his share of SBPC to his attorney in this action, John Berman.

When Emmert and Jehnke learned that Taggart had transferred his interest in SPBC to Berman, they sued Taggart and Berman in Oregon state court, asserting that the transfer breached SPBC's operating agreement because Taggart did not provide the notice required to allow Emmert and Jehnke to exercise their right of first refusal to buy Taggart's interest at the agreed upon price. The state court action also sought attorneys' fees pursuant to the operating agreement. Taggart filed an answer to the state court action, sought to dismiss the action, and filed a counterclaim for attorneys' fees pursuant to the operating agreement.

***441** On November 4, 2009, shortly before trial in the state court action, Taggart filed a voluntary Chapter 7 Bankruptcy petition (the "Petition"). The state court action was stayed pending the resolution of Taggart's bankruptcy Petition. On February 23, 2010, Taggart received his discharge in the bankruptcy proceedings.

After the discharge, Emmert and Jehnke, represented by attorney Stuart Brown, continued the state court action against Berman and Taggart. As part of the litigation, Brown served Taggart with a subpoena for a deposition. Taggart, represented by Berman, moved for a protective order that would allow him not to appear at the deposition, but the state trial court never ruled on the motion. Nonetheless, Taggart appeared for his deposition.

Prior to trial, Berman moved on Taggart's behalf to dismiss the claims against Taggart in light of the bankruptcy discharge. The state court denied the motion, finding that Taggart was a necessary party to Emmert and Jehnke's claims seeking to expel Taggart from SPBC, but the parties agreed that no monetary judgment would be awarded against Taggart. Taggart did not appear at or participate in the trial, but Berman orally renewed his motion to dismiss on Taggart's behalf at the close of evidence. The state court once again denied the motion.

After trial, the state court issued findings of fact and conclusions of law that unwound the transfer of Taggart's interest in SPBC to Berman and expelled Taggart from SPBC. Brown submitted a proposed judgment, to which Berman objected. Taggart appeared at the hearing for entry of the judgment and provided testimony and argument.

Following the hearing, the state court entered a judgment that allowed any party to petition for attorneys' fees. The litigation regarding attorneys' fees spawned a complex, interrelated web of litigation in both state and federal court.

First, Brown filed a petition for attorneys' fees in state court on behalf of SPBC, Emmert, and Jehnke. Brown's fee petition sought to recover fees against both Berman and Taggart, but limited the request for fees against Taggart to those fees that had been incurred after the date of Taggart's bankruptcy discharge. In the fee petition, Brown alerted the state court to the existence of Taggart's bankruptcy discharge and argued that Taggart could still be held liable for attorneys' fees incurred after Taggart's discharge because Taggart had "returned to the fray." That is, SPBC, Emmert, and Jehnke claimed Taggart had willingly engaged in opposing them in the state court action after Taggart obtained his bankruptcy discharge. Taggart opposed Brown's petition for attorneys' fees, arguing his bankruptcy discharge barred any claim for attorneys' fees, whether they were incurred before or after his discharge in bankruptcy.

While the attorneys' fee petition was pending in state court, Taggart moved the bankruptcy court to reopen his bankruptcy proceeding. The day the bankruptcy court reopened Taggart's bankruptcy proceeding, Taggart filed a motion seeking to hold Brown, Jehnke, Emmert, and SPBC (collectively, the "Creditors") in contempt for violating the discharge by seeking an award of attorneys' fees against him in the state court action.

[1]Meanwhile, the state trial court issued a ruling awarding attorneys' fees to SPBC, but not Jehnke and Emmert. The state court ruled that Taggart could be held liable for attorneys' fees that were incurred after his bankruptcy discharge ***442**

because he had "returned to the fray."[1] Taggart appealed the state court's determination to the Oregon Court of Appeals. *See Sherwood Park Bus. Ctr., LLC v. Taggart*, 267 Or.App. 217, 341 P.3d 96 (2014).

Subsequently, the bankruptcy court denied Taggart's motion for contempt, finding that the state court had correctly decided the issue: whether Taggart had indeed "returned to the fray." Taggart appealed the bankruptcy court's ruling to the district court. The district court reversed, finding that Taggart's actions were insufficient to constitute a "return to the fray" and, as a result, the discharge injunction barred the attorneys' fee claim. The district court remanded to the bankruptcy court for a determination of whether the Creditors "knowingly violated the discharge injunction in seeking attorney fees."[2]

On remand, the bankruptcy court found the Creditors had knowingly violated the discharge injunction by seeking attorneys' fees in the state action and entered an order holding them in contempt. Following further proceedings, the bankruptcy court awarded sanctions against SPBC, Emmert, Jehnke, and Brown's estate,[3] pursuant to the court's contempt ruling.

The Creditors appealed the bankruptcy court's contempt ruling to the Bankruptcy Appellate Panel ("BAP"). On appeal, the BAP reversed the bankruptcy court's finding of contempt. The BAP reasoned that the Creditors could not be held in contempt unless they "knowingly" violated the discharge injunction. Because the BAP found that the Creditors had a good faith belief that the discharge injunction did not apply to their attorneys' fee claim, it concluded that they had not "knowingly" violated the discharge injunction.

In the meantime, the Oregon Court of Appeals reversed the state trial court's ruling regarding attorneys' fees. *See Taggart*, 341 P.3d at 102–04. In line with the district court, the Oregon Court of Appeals held that Taggart's actions were not sufficiently affirmative or voluntary to constitute a "return to the fray." *Id.* As a result, the court concluded that the discharge injunction barred the recovery of attorneys' fees. *Id.*

Ultimately, the Creditors were barred from pursuing attorneys' fees against Taggart by the rulings of both the district court and the Oregon Court of Appeals. Additionally, due to the BAP's ruling, the Creditors were not liable for sanctions for knowingly violating the discharge injunction by seeking attorneys' fees against Taggart in the state court litigation.

Taggart filed a notice of appeal challenging the BAP's decision to reverse the bankruptcy court's contempt findings against the Creditors. The Creditors filed a notice of cross-appeal challenging the district court's ruling that Taggart had not returned to the fray in the state court litigation.

I

[2]We begin with Taggart's appeal, in which he argues that the BAP committed ***443** reversible error when it held that the Creditors could not be held in contempt because they did not *knowingly* violate the discharge injunction. A discharge under Chapter 7 of the bankruptcy code "discharges the debtor from all debts that arose before the date of the" bankruptcy petition. 11 U.S.C. § 727(b). Once issued, the discharge "operates as an injunction against the commencement or continuation of an action ... to collect, recover or offset any such debt as a personal liability of the debtor." 11 U.S.C. § 524(a)(2). A bankruptcy court may enforce the discharge injunction by holding a party in contempt for knowingly violating the discharge. *In re Zilog, Inc.*, 450 F.3d 996, 1007 (9th Cir. 2006).

In this case, after the district court concluded that Taggart had not "returned to the fray," it remanded the case to the bankruptcy court for a determination of whether the Creditors should be held in contempt. The bankruptcy court determined that the Creditors were aware of the discharge order, but proceeded with their efforts to recover attorneys' fees from Taggart. The bankruptcy court concluded that it was irrelevant whether the Creditors held a subjective good faith belief that the discharge injunction did not apply to their claim. As a result, the bankruptcy court held that the Creditors had committed a

knowing violation of the discharge injunction and it held them in contempt.

On appeal, the BAP reversed. The BAP concluded that the Creditors had a subjective good faith belief that their claim was exempt from the discharge injunction. In light of this good faith belief, the BAP held that the Creditors did not "knowingly" violate the discharge injunction, even though an actual violation had occurred.

[3] [4] [5]We review the BAP's decisions de novo. *In re Filtercorp, Inc.*, 163 F.3d 570, 576 (9th Cir. 1998). The bankruptcy court's decision to impose contempt sanctions is reviewed for an abuse of discretion. *In re Dyer*, 322 F.3d 1178, 1191 (9th Cir. 2003). A bankruptcy court abuses its discretion if its decision is based on an incorrect legal rule, or if its "application of the correct legal standard was (1) 'illogical,' (2) 'implausible,' or (3) without 'support in inferences that may be drawn from the facts in the record.' " *United States v. Hinkson*, 585 F.3d 1247, 1262 (9th Cir. 2009) (quoting *Anderson v. City of Bessemer*, 470 U.S. 564, 577, 105 S.Ct. 1504, 84 L.Ed.2d 518 (1985)).

[6] [7]"The standard for finding a party in civil contempt is well settled: The moving party has the burden of showing by clear and convincing evidence that the contemnors violated a specific and definite order of the court. The burden then shifts to the contemnors to demonstrate why they were unable to comply." *In re Bennett*, 298 F.3d 1059, 1069 (9th Cir. 2002) (quoting *F.T.C. v. Affordable Media,* 179 F.3d 1228, 1239 (9th Cir.1999)). As noted above, a bankruptcy court may hold a party in contempt for knowingly violating the discharge injunction. *Zilog*, 450 F.3d at 1007. We have adopted a two-part test for determining the propriety of a contempt sanction in the context of a discharge injunction: "[T]o justify sanctions, the movant must prove that the creditor (1) knew the discharge injunction was applicable and (2) intended the actions which violated the injunction." *Bennett*, 298 F.3d at 1069.

[8] [9]Only the first prong of the test is at issue here. To satisfy the first prong, knowledge of the applicability of the injunction must be proved as a matter of fact and may not be inferred simply because the creditor knew of the bankruptcy proceeding. *Zilog*, 450 F.3d at 1007–08; *see also Dyer*, 322 F.3d at 1191–92 (rejecting ***444** an attempt to infer knowledge of the automatic stay based on knowledge of the bankruptcy proceedings in the context of a contempt ruling).[4] Additionally, the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable. *Zilog*, 450 F.3d at 1009 n.14 ("To the extent that the deficient notices [from the bankruptcy court and opposing counsel] led the [creditors] to believe, even unreasonably, that the discharge injunction did not apply to their claims because they were not affected by the bankruptcy, this would preclude a finding of willfulness.").

[10]In this case, the bankruptcy court abused its discretion by concluding that the Creditors knowingly violated the discharge injunction. Specifically, the bankruptcy court abused its discretion by applying an incorrect rule of law. *See Hinkson*, 585 F.3d at 1262. The bankruptcy court held that a good faith belief that the discharge injunction was inapplicable to the Creditors' claims was irrelevant for purposes of determining whether there was a "knowing" violation of the discharge injunction. This holding conflicts with *Zilog*, where we stated that even an unreasonable belief that the discharge injunction did not apply to a creditor's claims would preclude a finding of contempt. 450 F.3d at 1009 n.14.

It is true, as Taggart points out, that language from our prior opinions in *Bennett* and *Dyer* appears to be somewhat in tension with *Zilog*.[5] However, neither *Bennett* nor *Dyer* held that a creditor's subjective good faith belief that the discharge injunction is inapplicable is irrelevant to the contempt analysis. In fact, *Bennett* expressly states that the creditor must know that the discharge injunction is "applicable" to the creditor's claims, and *Dyer* cited that holding with approval. *Bennett*, 298 F.3d at 1069; *Dyer*, 322 F.3d at 1192. Regardless, *Zilog*'s statement of the law is clear, directly addresses the question at issue in here, and is binding on this court.

In this case, as the BAP found, the Creditors possessed a good faith belief that the discharge injunction did not apply to their claims based on their contention that Taggart had "returned to the fray," and Taggart does not contend otherwise. Much like the creditors in *Zilog* relied on statements by the debtor's counsel and the bankruptcy court in concluding that their claims were not impacted by the discharge injunction, the Creditors relied on the state court's judgment that the discharge injunction did not apply to their claim for post-petition attorneys' fees. Although the Creditors—like the creditors in *Zilog*—were ultimately incorrect, their good faith belief, even if unreasonable, insulated them from a finding of contempt.

at 1009 n.14. As a result, the BAP did not err when it reversed the contempt sanctions ***445** entered by the bankruptcy court against the Creditors.

II

Because we have determined that the Creditors cannot be held in contempt for any alleged violation of the discharge injunction, we need not reach the arguments raised in the Creditors' cross-appeal regarding the district court's holding that the Creditors violated the discharge injunction by seeking an attorneys' fee award in the state court litigation.[6] Even if the Creditors did violate the discharge injunction—and we express no opinion as to whether they did or did not—they cannot be held in contempt for that alleged violation. As discussed above, they acted pursuant to their good faith belief that, due to Taggart's "return to the fray," the discharge injunction did not apply to their claims. As a result, we decline to reach the issues raised by the Creditors' Cross-Appeal.

III

In light of the above, we **AFFIRM** the BAP's opinion reversing the bankruptcy court's order entering contempt sanctions against the Creditors.

All Citations

888 F.3d 438, 65 Bankr.Ct.Dec. 145, Bankr. L. Rep. P 83,243, 18 Cal. Daily Op. Serv. 3770, 2018 Daily Journal D.A.R. 3551

Footnotes

1 Whether Taggart had "returned to the fray" was significant because if a debtor "returns to the fray" by engaging in post-bankruptcy petition litigation, a creditor may seek an attorneys' fee award if the new litigation was not within the "fair contemplation of the parties" prior to the bankruptcy petition. *See In re Castellino Villas, A. K. F. LLC*, 836 F.3d 1028, 1034–37 (9th Cir. 2016).

2 Emmert, Brown, Jehnke, and SPBC filed a notice of appeal of the district court's decision. This court dismissed the appeal because the district court's ruling was not a final order.

3 Brown passed away in 2013. Shelley Lorenzen represents Brown in this litigation as the executor of his estate.

4 Although *Dyer* dealt with a violation of the automatic stay, rather than a violation of the discharge injunction, the sanctions at issue were not imposed under the bankruptcy code provision that specifically allows sanctions for a violation of the automatic stay, 11 U.S.C. § 362(h). *Dyer*, 322 F.3d at 1189. Rather, sanctions were imposed under the bankruptcy court's 11 U.S.C. § 105(a) contempt authority, thereby invoking the standard that applies when there is a violation of the discharge injunction. *Id.*

5 Taggart specifically highlights language from *Dyer*, which states: "In determining whether the contemnor violated the stay, the focus 'is not on the subjective beliefs or intent of the contemnors in complying with the order, but whether in fact their conduct complied with the order at issue.' " 322 F.3d at 1191 (quoting *In re Hardy*, 97 F.3d 1384, 1390 (11th Cir. 1996)).

6 After the district court's decision in this case, but before the parties completed their briefing in our court, another Ninth Circuit

panel issued an opinion in *In re Castellino Villas, A. K. F. LLC*, 836 F.3d 1028, 1034 (9th Cir. 2016). Lorenzen's briefing to this court recognized the *Castellino Villas* opinion and noted that, in Lorenzen's view, *Castellino Villas* commands resolution of whether Creditors violated the discharge against the Creditors. At the time of briefing in this case, *Castellino Villas* had been decided, but could have been reheard by an en banc panel of this court or overturned or modified by the Supreme Court. Lorenzen requested that we deem her cross-appeal withdrawn if *Castellino Villas* was not overturned or modified. Because *Castellino Villas* has neither been overturned nor modified, we grant Lorenzen's request to withdraw her cross-appeal. Therefore, we do not address it.

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892 F.3d 29
United States Court of Appeals, First Circuit.

INTERNAL REVENUE SERVICE, Defendant, Appellant,
v.
William Charles MURPHY, Plaintiff, Appellee.

No. 17-1601
|
June 7, 2018

Synopsis
Background: Debtor brought action against Internal Revenue Service (IRS) alleging an employee of the IRS willfully violated bankruptcy court's discharge order by issuing levies against insurance companies with which debtor did business in an attempt to collect on debtor's discharged tax obligations. Parties entered into settlement agreement whereby IRS accepted that debtor's tax obligations had been discharged, but reserved the right to appeal issue of damages, and United States Bankruptcy Court for the District of Maine entered final judgment against IRS. IRS appealed. The United States District Court for the District of Maine, D. Brock Hornby, J., affirmed. IRS appealed.

[Holding:] The Court of Appeals, Stahl, Circuit Judge, held that an IRS officer or employee commits a "willful violation" of an automatic stay or a discharge order if the individual knows of the stay or discharge order and takes an intentional action that violates the stay or order.

Affirmed.

Lynch, Circuit Judge, wrote dissenting opinion.

West Headnotes (19)

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

The Court of Appeals reviews the bankruptcy court's resolution of a legal question de novo.

Cases that cite this headnote

[2] **Statutes** Language

All inquiries into interpretation of a statute must begin with the language of the statute itself.

Cases that cite this headnote

[3] **Statutes** Undefined terms
Statutes Context

Courts attribute to words that are not defined in the statute itself their ordinary usage, while keeping in mind that meaning can only be ascribed to statutory language if that language is taken in context.

Cases that cite this headnote

[4] **Criminal Law** Criminal Intent and Malice

At a minimum, term "willfully" differentiates between deliberate and unwitting conduct.

Cases that cite this headnote

[5] **Criminal Law** Criminal Intent and Malice

In criminal law, term "willfully" typically refers to a culpable state of mind, such that a "willful violation" occurs only when a defendant acts with knowledge that his conduct is unlawful.

Cases that cite this headnote

[6] **Negligence** Willful or wanton conduct

Civil use of the term "willfully" typically presents neither the textual nor the substantive reasons for pegging the threshold of liability at knowledge of wrongdoing.

Cases that cite this headnote

[7] **Statutes** Prior or existing law in general

In interpreting a statute, courts generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts.

Cases that cite this headnote

[8] **Statutes** Similar or related statutes

The presumption that Congress is knowledgeable about existing law pertinent to legislation it enacts is particularly appropriate when the new legislation invokes and builds off an existing statutory framework.

Cases that cite this headnote

[9] **Bankruptcy** Automatic Stay

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws; it gives a breathing spell to the debtor and stops all collection efforts, all harassment, and all foreclosure actions.

Cases that cite this headnote

[10] **Bankruptcy** Discharge as injunction

A discharge order under bankruptcy statute generally relieves a debtor from all pre-petition debt and permanently enjoins creditor actions to collect discharged debts. 11 U.S.C.A. § 524(a).

Cases that cite this headnote

[11] **Internal Revenue** Reasonableness or merits of government's position; bad faith

Exception to rule permitting a taxpayer who prevails in an action against the Internal Revenue Service (IRS) to recover reasonable attorney fees if the IRS establishes that the its position was substantially justified acknowledges that liability under the code may flow from good faith actions of the IRS, but that substantial justification may mitigate the damages available to the aggrieved party. 26 U.S.C.A. § 7430(c)(4)(B).

Cases that cite this headnote

[12] **Bankruptcy** Tax proceedings
Internal Revenue Remedies for Wrongful Enforcement

While the Internal Revenue Service (IRS) could not rely on its good faith belief that it could collect from debtor as a defense to liability to debtor for violating bankruptcy court's order discharging all of debtor's debt, it could invoke its good faith belief to limit debtor's recovery to his actual damages. 26 U.S.C.A. §§ 7430(c)(4)(B), 7433(e).

Cases that cite this headnote

[13] **Bankruptcy** Tax proceedings
Internal Revenue Remedies for Wrongful Enforcement

Under statute providing for civil damages for unauthorized collection of taxes, an Internal Revenue Service (IRS) officer or employee commits a "willful violation" of an automatic stay or a discharge order issued under bankruptcy code if the individual knows of the stay or discharge order and takes an intentional action that violates the stay or order, notwithstanding the individual's good faith belief that IRS has the right to collect the debt. 11 U.S.C.A. §§ 362, 524; 26 U.S.C.A. § 7433(e).

Cases that cite this headnote

[14] **Internal Revenue** Other determinations

Although the Internal Revenue Manual does not have the force and effect of law, courts may rely on it to the extent they find it persuasive.

Cases that cite this headnote

[15] **United States** Construction of waiver or consent in general

Courts construe any ambiguities in the scope of a waiver of sovereign immunity in favor of the sovereign.

Cases that cite this headnote

[16] **United States** Construction of waiver or consent in general

The canon that courts construe any ambiguities in the scope of a waiver of sovereign immunity in favor of the

sovereign is a tool for interpreting the law and it does not displace the other traditional tools of statutory construction.

Cases that cite this headnote

[17] **United States** Construction of waiver or consent in general

In construing a waiver of sovereign immunity, courts must be careful not to be more stinting in the interpretation of the provision than its language requires, for just as the courts should not construe a waiver of sovereign immunity more broadly than Congress intended, neither, however, should courts assume the authority to narrow the waiver that Congress intended.

Cases that cite this headnote

[18] **United States** Construction of waiver or consent in general

When considering the scope of a waiver of sovereign immunity, a narrower temporal approach, looking at congressional understanding of the enumerated sections at the time of the enactment, is preferable, in part because the approach adheres to the general principle that Congress is presumed to know the content of background law.

Cases that cite this headnote

[19] **Bankruptcy** Determination of Dischargeability

The Internal Revenue Service (IRS) need not appear and object in a bankruptcy court to have a tax debt be excepted from a discharge; it remains free to wait until the bankruptcy discharge is invoked as a defense to its collection efforts, and then prove a factual basis for the tax fraud exception in the collection proceedings. 11 U.S.C.A. § 523(a)(1)(C).

Cases that cite this headnote

***31** APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MAINE [Hon. D. Brock Hornby, U.S. District Judge]

Attorneys and Law Firms

Peter Sklarew, with whom David A. Hubbert, Acting Assistant Attorney General, Paul A. Allulis, Gilbert S. Rothernberg,

Thomas J. Clark, Attorneys, Tax Division, Department of Justice, and Halsey B. Frank, United States Attorney, were on brief, for appellant.

John H. Branson, with whom Branson Law Office, P.A., Portland, ME, was on brief, for appellee.

Before Lynch, Circuit Judge, Souter, Associate Justice,* and Stahl, Circuit Judge.

Opinion

STAHL, Circuit Judge.

***32** In this case, we need to determine whether an employee of the Internal Revenue Service ("IRS") "willfully violate[d]" an order from the bankruptcy court discharging the debts of debtor-taxpayer William C. Murphy, as that term is used in 26 U.S.C. § 7433(e). After careful consideration, we hold that an employee of the IRS "willfully violates" a discharge order when the employee knows of the discharge order and takes an intentional action that violates the order. Under § 7433(e), the IRS's good faith belief that it has a right to collect the purportedly discharged debts is not relevant to determining whether it "willfully violate[d]" the discharge order. Because the IRS's actions in this case meet this standard, we affirm.

I.

On October 13, 2005, Murphy filed a Chapter 7 petition in the United States Bankruptcy Court for the District of Maine. On Schedule E of his bankruptcy petition, Murphy listed his income tax obligations to the IRS for the years of 1993-1998, 2000, 2001, and 2003, as well as a 2003 tax obligation to the Maine Revenue Services. Murphy's tax obligations were by far the largest liabilities he sought to discharge. In his petition, Murphy listed total liabilities of $601,861.61, of which $546,161.61 were tax obligations. On January 20, 2006, Assistant U.S. Attorney Frederick Emery, Jr. ("AUSA Emery") filed an appearance on behalf of the IRS in the bankruptcy proceeding.

On February 14, 2006, the bankruptcy court granted Murphy a discharge. The discharge order, which appears to be a standard form, reads:

> It appearing that the debtor is entitled to a discharge,
>
> **IT IS ORDERED:**
>
> The debtor is granted a discharge under section 727 of title 11, United States Code, (the Bankruptcy Code).

Beneath the bankruptcy judge's signature, there is a notice that states, in bold and capital letters, "**SEE THE BACK OF THIS ORDER FOR IMPORTANT INFORMATION.**" The back of the order provides an explanation of bankruptcy discharge in a Chapter 7 case, stating that "[t]he discharge prohibits any attempt to collect from the debtor a debt that has been discharged." The order lists "[s]ome of the common types of debts which are *not* discharged" and specifically notes that "[d]ebts for most taxes" are not discharged.

It does not appear that the IRS objected to Murphy's discharge prior to the bankruptcy court entering its discharge order. On February 16, 2006, the IRS received notice of the discharge order.

The IRS did not believe that the discharge relieved Murphy of his tax obligations. Rather, the IRS viewed Murphy's taxes as

excepted from discharge under 11 U.S.C. § 523(a)(1)(C), which excepts from discharge any tax if "the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." Based on its earlier investigations into Murphy, the IRS believed that Murphy had willfully attempted to evade taxes during all of the years in question.

From February 2006 to February 2009, the IRS repeatedly informed Murphy that it did not view his tax obligations as discharged and that it planned to collect what it believed was owed. On February 20, 2009, the IRS issued levies against several insurance companies with which Murphy then did business in an attempt to collect on these tax obligations. Margurite Gagne, a revenue officer for the IRS, signed the levy notices sent to the insurance companies.

***33** On August 14, 2009, Murphy filed an adversarial proceeding seeking a declaration that his tax obligations from 1993-1998, 2000, and 2001 had been discharged. In this proceeding, AUSA Emery represented the IRS. According to the IRS, AUSA Emery "took only minimal discovery in the case" and failed to submit evidence to the bankruptcy court that the IRS had developed during its investigation into Murphy's tax obligations. Instead, the IRS claims that AUSA Emery merely filed a summary of the IRS's allegations of Murphy's tax evasion, without submitting any admissible evidence to support the allegations.

On June 22, 2010, the bankruptcy court granted summary judgment in Murphy's favor and declared that Murphy's tax obligations had been discharged. The bankruptcy court later noted that it granted summary judgment in large part because the IRS's opposition to summary judgment "fell far short of applicable substantive and procedural standards." Murphy v. IRS (In re Murphy), No. 05-22363, 2013 WL 6799251, at *2 (Bankr. D. Me. Dec. 20, 2013). The IRS did not appeal the bankruptcy court's 2010 summary judgment ruling.

Subsequently, AUSA Emery was diagnosed with frontotemporal dementia ("FTD"). According to the IRS, symptoms of FTD include "impairment of executive function, such as the cognitive skill of planning and organizing." Based on AUSA Emery's medical records and the opinions of three physicians, the IRS believes that AUSA Emery was already experiencing the symptoms of FTD in 2010.

In February 2011, Murphy filed a complaint against the IRS under § 7433(e), alleging that an employee of the IRS willfully violated the bankruptcy court's 2006 discharge order in February 2009 by issuing levies against the insurance companies with which he did business and thereby attempting to collect on his discharged tax obligations.[1] The IRS responded that it did not willfully violate the order because it reasonably believed his tax obligations were excepted from discharge under § 523(a)(1)(C) based on its investigation into his alleged tax evasion.

On December 20, 2013, the bankruptcy court granted summary judgment for Murphy for his § 7433(e) claim. The court found that the term "willfully violates" has an established meaning in the context of violations of automatic stays and discharge orders issued in bankruptcy proceedings: a willful violation occurs "when, with knowledge of the discharge, [a creditor] intends to take an action, and that action is determined to be an attempt to collect a discharged debt." In re Murphy, 2013 WL 6799251, at *7. The court further found that the 2010 summary judgment ruling collaterally estopped the IRS from relitigating whether Murphy's tax obligations were discharged, whether the IRS knew they were discharged, and whether it took actions which violated the discharge order. Id. at *8.

After the bankruptcy court denied the IRS's motion for reconsideration, the IRS appealed to the district court, which vacated the bankruptcy court's decision. IRS v. Murphy, 564 B.R. 96, 98 (D. Me. 2016). The district court concluded that the bankruptcy court should have considered AUSA Emery's impairment before finding that the 2010 summary judgment ruling collaterally estopped the IRS from relitigating ***34** issues related to Murphy's discharge. Id. at 112.

However, the district court agreed with the bankruptcy court's definition of "willfully violates" as used in § 7433(e). Id. at 106. The district court found that, by 1998, the term had an established meaning in the context of violations of both automatic stays and discharge injunctions, and under this established meaning, a creditor's "good faith belief in a right to the property is not relevant to a determination of whether the violation was willful." Id. (quoting Fleet Morg. Grp., Inc. v. Kaneb, 196 F.3d 265, 269 (1st Cir. 1999)).

On remand, the parties entered into a settlement agreement, whereby the IRS waived its collateral estoppel arguments and accepted that the 2010 summary judgment ruling conclusively determined that Murphy's tax obligations had been discharged. The IRS reserved the right:

> for further appeal(s) only its arguments that that [sic] a debtor is not entitled to damages where a creditor's violation of the discharge reflects a reasonable belief that the debt involved was excepted from discharge, and/or that the "willfully violates" language in IRS § 7433(e) should be construed to permit the IRS to defend against liability for violating the discharge on the basis that its employee reasonably believed that the tax involved is excepted from discharge [hereinafter "the willfully violates issue"].

As part of the settlement, the IRS agreed to pay $175,000 as Murphy's damages once it had exhausted the reserved right to appeal if the appeal was lost. The settlement did not "resolve whether or not the deficiencies in in [sic] the United States' response to plaintiff's motion for summary judgment ... were caused by any mental disability of the former Assistant United States Attorney at the time of the summary judgment proceedings." Based on this agreement, on January 4, 2017, the bankruptcy court entered final judgment against the United States, and the district court affirmed the judgment on appeal. The IRS timely appeals to this court.[2]

II.

[1]We are, at this stage, confronted solely with the bankruptcy court's resolution of a legal question, which we review de novo. Wilding v. CitiFinancial Consumer Fin. Servs., Inc., (In re Wilding), 475 F.3d 428, 430 (1st Cir. 2007). The parties' settlement agreement reserved for the IRS the right to appeal only the bankruptcy court's construction of the phrase "willfully violates" as used in § 7433(e).

The IRS argues it does not "willfully violate" an automatic stay or discharge order if it has a good faith belief that its actions do not violate the bankruptcy court's order. In support of its position, the IRS presents two somewhat conflicting arguments. First, it claims that, before Congress enacted § 7433(e) in 1998, all creditors could raise a good faith defense to allegations that they willfully violated an automatic stay or discharge order. Second, it posits that even if most creditors could not raise a good faith defense, such a defense must be available to the IRS because § 7433(e) is a waiver of sovereign immunity that must be construed narrowly.

***35** [2] [3]We begin our interpretation of § 7433(e) "where all such inquiries must begin: with the language of the statute itself." Ransom v. FIA Card Servs., N.A., 562 U.S. 61, 69, 131 S.Ct. 716, 178 L.Ed.2d 603 (2011) (quoting United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989)). Section 7433(e) provides that:

> If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service willfully violates any provision of section 362 (relating to automatic stay) or 524 (relating to effect of discharge) of title 11, United States Code (or any successor provision), ... such taxpayer may petition the bankruptcy court to recover damages against the United States. (emphasis added).

Congress did not define "willfully" or the phrase "willfully violates" as used in § 7433(e). "[W]e attribute to words that are not defined in the statute itself their ordinary usage, while keeping in mind that meaning can only be ascribed to statutory language if that language is taken in context." Brady v. Credit Recovery Co., Inc., 160 F.3d 64, 66 (1st Cir. 1998).

[4] [5] [6]"The statutory term 'willfully' is a chameleon." United States v. Marshall, 753 F.3d 341, 345 (1st Cir. 2014). At a

minimum, "willfully" "differentiates between deliberate and unwitting conduct." Bryan v. United States, 524 U.S. 184, 191, 118 S.Ct. 1939, 141 L.Ed.2d 197 (1998); see also McLaughlin v. Richland Shoe Co., 486 U.S. 128, 133, 108 S.Ct. 1677, 100 L.Ed.2d 115 (1988) ("In common usage the word 'willful' is considered synonymous with such words as 'voluntary,' 'deliberate,' and 'intentional.' "). In criminal law, it "typically refers to a culpable state of mind," such that a "willful violation" occurs only when a defendant "act[s] with knowledge that his conduct [is] unlawful." Bryan, 524 U.S. at 191-92, 118 S.Ct. 1939. In contrast, "[c]ivil use of the term ... typically presents neither the textual nor the substantive reasons for pegging the threshold of liability at knowledge of wrongdoing." Safeco Ins. Co. of Am. v. Burr, 551 U.S. 47, 57 n.9, 127 S.Ct. 2201, 167 L.Ed.2d 1045 (2007).

In sum, as the Supreme Court has repeatedly stated, " 'willfully' is a 'word of many meanings whose construction is often dependent on the context in which it appears.' " Id. at 57, 127 S.Ct. 2201 (quoting Bryan, 524 U.S. at 191, 118 S.Ct. 1939); see also Ratzlaf v. United States, 510 U.S. 135, 141, 114 S.Ct. 655, 126 L.Ed.2d 615 (1994); United States v. Murdock, 290 U.S. 389, 394-95, 54 S.Ct. 223, 78 L.Ed. 381 (1933). We look then to the context in which the word "willfully" appears in § 7433(e) to ascertain its meaning.

[7] [8]Section 7433(e) directly links the phrase "willfully violates" to two pre-existing sections of the Bankruptcy Code: section 362, which addresses automatic stays, and section 524, which addresses discharges and discharge orders. "We generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts." Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 184-85, 108 S.Ct. 1704, 100 L.Ed.2d 158 (1988). This presumption is particularly appropriate when the new legislation invokes and builds off an existing statutory framework. See, e.g., Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 126, 105 S.Ct. 613, 83 L.Ed.2d 523 (1985). We turn then to examine how courts had interpreted sections 362 and 524 of the Bankruptcy Code in the years before Congress enacted § 7433(e), looking first at violations of automatic stays and then turning to violations of discharge orders.

***36 III.**

A.

[9]The automatic stay is "one of the fundamental debtor protections provided by the bankruptcy laws." Midlantic Nat. Bank v. N.J. Dept. of Envtl. Prot., 474 U.S. 494, 503, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) (quoting S. Rep. No 95-989, p. 54 (1978); H.R. Rep No. 95-595, p. 340 (1977)). "The stay gives a 'breathing spell' to the debtor and stops 'all collection efforts, all harassment, and all foreclosure actions.' " Tringali v. Hathaway Mach. Co., Inc., 796 F.2d 553, 562 (1st Cir. 1986) (quoting H.R. Rep. No. 95-595, p. 340).

Congress enacted then-section 362(h) of the Bankruptcy Code in 1984 to provide a private cause of action to "[a]n individual injured by any willful violation of a stay...." 11 U.S.C. § 362(h) (West 1998); see Vahlsing v. Comm. Union Ins. Co., Inc., 928 F.2d 486, 489 n.1 (1st Cir. 1991).[3] Before this provision was added to the Bankruptcy Code, some courts had imposed sanctions for willful violations of automatic stays "pursuant to the authority of bankruptcy courts to order parties in contempt." Crysen/Montenay Energy Co. v. Esselen Assocs., Inc. (In re Crysen/Montenay Energy Co.), 902 F.2d 1098, 1104 (2d Cir. 1990). For this reason, the standard courts had used for evaluating whether a violation was willful was the standard that "governed contempt proceedings: a party generally would not have sanctions imposed ... as long as it had acted without maliciousness and had had a good faith argument and belief that its actions did not violate the stay." Id. However, because § 362(h) created "an independent statutory basis" to hold violators of the automatic stay liable, courts began to apply "a standard less stringent than maliciousness or bad faith to govern the imposition of sanctions in bankruptcy cases." Id.

Prior to the enactment of § 7433(e), nearly all courts, and a majority of the circuits, had held that a willful violation of an automatic stay under § 362(h) occurs when an individual knows of the automatic stay and takes an intentional action that violates the automatic stay. See, e.g., Jove Eng'g, Inc. v. IRS (In re Jove Eng'g, Inc.), 92 F.3d 1539, 1555 (11th Cir. 1996); Price v. United States (In re Price), 42 F.3d 1068, 1071 (7th Cir. 1994); In re Crysen/Montenay Energy Co., 902 F.2d at 1105; Cuffee v. Atl. Bus. & Cmty. Corp. (In re Atl. Bus. & Cmty. Corp.), 901 F.2d 325, 329 (3d Cir. 1990); Knaus v. Concordia Lumber Co. (In re Knaus), 889 F.2d 773, 775 (8th Cir. 1989); Goichman v. Bloom (In re Bloom), 875 F.2d 224, 227 (9th Cir. 1989); Budget Serv. Co. v. Better Homes of Virginia, 804 F.2d 289, 292-93 (4th Cir. 1986). These courts refused to incorporate a bad faith or maliciousness requirement, and in fact many specifically rejected good faith defenses. In re Crysen/Montenay Energy Co., 902 F.2d at 1104-05; In re Atl. Bus. & Cmty. Corp., 901 F.2d at 329; see also Pinkstaff v. United States (In re Pinkstaff), 974 F.2d 113, 115 (9th Cir. 1992) ("As it is undisputed that the IRS acted with knowledge of the bankruptcy filing, it necessarily follows that the government willfully violated the automatic stay." (internal quotation marks and citations omitted)).

Contemporary versions of leading bankruptcy treatises defined a "willful violation" of the automatic stay in the same manner. See George M. Treister et al., Fundamentals of Bankruptcy Law (4th ed. 1996) § 5.01(c) ("A willful violation of the stay ... does not require an intent to violate nor an awareness that the conduct was prohibited by the stay. It suffices that ***37** the violator knew of the existence of the stay, i.e., that he knew of the pendency of the bankruptcy, and that he intentionally did the violating act."); David G. Epstein et al., Bankruptcy (1992) § 3-33(c) ("A specific intent to violate the stay is not required, or even an awareness by the creditor that her conduct violates the stay. It is sufficient that the creditor knows of the bankruptcy and engages in deliberate conduct that, it so happens, is a violation of the stay."). These contemporary sources further show that the phrase "willful violation" had a generally accepted meaning at the time Congress enacted § 7433(e). See Hamilton v. Lanning, 560 U.S. 505, 515-16, 130 S.Ct. 2464, 177 L.Ed.2d 23 (2010) (considering circuit court decisions and contemporary bankruptcy treatises when interpreting undefined term in the Bankruptcy Code).

The IRS claims that before 1998, a few circuits, including this circuit, had adopted a "less stringent standard" that allowed alleged violators to raise a good faith defense. We disagree. The three circuit court decisions cited by the IRS do not provide an alternative definition of the phrase "willful violation." Nelson v. Taglienti (In re Nelson), 994 F.2d 42, 45 (1st Cir. 1993); Andrews Univ. v. Merchant (In re Merchant), 958 F.2d 738, 742 (6th Cir. 1992); Matter of Sherk (In re Sherk), 918 F.2d 1170, 1178 (5th Cir. 1990) abrogated on other grounds by Taylor v. Freeland & Kronz, 503 U.S. 638, 643, 112 S.Ct. 1644, 118 L.Ed.2d 280 (1992). Rather, these three decisions all appear to be limited resolutions of idiosyncratic fact patterns, with two arising in the context of domestic relations, see In re Nelson 994 F.2d at 45; In re Sherk, 918 F.2d at 1178, without a broader analysis of the meaning of "willful violation." Indeed, in In re Nelson, we avoided adopting a particular definition of "willful violation" by specifically limiting our holding to "the peculiar 'facts' of th[e] case." 994 F.2d at 45.[4]

A review of cases from within these circuits demonstrates that these three decisions did not announce an alternative "less stringent standard" for violations of automatic stays. Even after these decisions were issued, courts continued to apply the generally accepted definition of "willful violation" and rejected good faith defenses. See, e.g., Stmima Corp. v. Carrigg (In re Carrigg), 216 B.R. 303, 305 (B.A.P. 1st Cir. 1998); Shadduck v. Rodolakis, 221 B.R. 573, 577, 582-83 (D. Mass. 1998) (finding willful violation of automatic stay by IRS despite its argument that it acted in good faith); In re Walker, 168 B.R. 114, 121 (E.D. La. 1994) ("Willfulness is not measured by specific intent to violate a court order...."); In re Timbs, 178 B.R. 989, 997 (Bankr. E.D. Tenn. 1994) ("[A] good faith mistake of the law, a legitimate dispute as to legal rights or even good faith reliance on an attorney's advice do[es] not relieve a willful violator from the consequences of his act."); Smith v. GTE N. Inc. (In re Smith), 170 B.R. 111, 115, 117 (Bankr. N.D. Ohio 1994) (no good faith defense to willful violation of automatic stay).

The IRS also points to the Third Circuit's decision in University Medical Center v. Sullivan (In re University Medical Center), 973 F.2d 1065 (3d Cir. 1992) as an example of a court adopting a good faith defense for willful violations of automatic stays. It is true that, if read broadly, ***38** In re University Medical Center could allow a creditor to raise a good faith defense in any situation where existing law leads a creditor to reasonably believe "its actions to be in accord with the stay." Id. at 1088.[5] However, pre-1998 decisions from within the Third Circuit demonstrate that courts did not read In re University Medical Center so broadly. In a decision issued only eight months after In re University Medical Center, the Third

Circuit itself reaffirmed that "[w]illfulness does not require that the creditor intend to violate the automatic stay provision" and that "a creditor's 'good faith' belief that he is not violating the automatic stay provision is not determinative of willfulness under § 362(h)." Lansdale Family Rests., Inc. v. Weis Food Serv. (In re Lansdale Family Rests., Inc.), 977 F.2d 826, 829 (3d Cir. 1992) (citing In re Univ. Med. Ctr., 973 F.2d at 1087-88). And, in a case involving a taxpayer's suit against the IRS, the Bankruptcy Court for the Middle District of Pennsylvania rejected the IRS's argument that it relied in good faith on existing procedure set out in the IRS manual, concluding that "[e]ven a good faith belief that a party is not violating a stay is insufficient to escape liability." Weisberger v. United States (In re Weisberger), 205 B.R. 727, 731 (Bankr. M.D. Pa. 1997) (citing In re Univ. Med. Ctr., 973 F.2d at 1088).

In sum, we find the phrase "willful violation" had an established meaning in the context of violations of automatic stays as of 1998: a creditor willfully violated the automatic stay if it knew of the automatic stay and took an intentional action that violated the automatic stay. A good faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful.

B.

[10]A discharge order issued pursuant to § 524(a) generally "relieves a debtor from all pre-petition debt" and "permanently enjoins creditor actions to collect discharged debts." Bessette v. Avco Fin. Servs., Inc., 230 F.3d 439, 444 (1st Cir. 2000). In this way, the discharge order is designed "to ensure that debtors receive a 'fresh start' and are not unfairly coerced into repaying discharged prepetition debts." Pratt v. Gen. Motors Acceptance Corp. (In re Pratt), 462 F.3d 14, 19 (1st Cir. 2006); see also Hardy v. United States (In re Hardy), 97 F.3d 1384, 1388-89 (11th Cir. 1996) (discussing how § 524 "embodies the 'fresh start' concept of the bankruptcy code").

By 1998, bankruptcy courts had relied on their equitable powers, granted by § 105(a), to sanction parties that willfully violated discharge orders, see Bessette, 230 F.3d at 445 (citing In re Hardy, 97 F.3d at 1389; In re Elias, 98 B.R. 332, 337 (N.D. Ill. 1989); Matthews v. United States (In re Matthews), 184 B.R. 594, 598 (Bankr. S.D. Ala. 1995)), and had begun to apply the same generally accepted definition of "willful violation" used for violations of automatic stays to violations of discharge orders. In In re Hardy, the Eleventh Circuit used the same willfulness definition when determining whether the IRS violated a debtor's discharge order. 97 F.3d at 1390. Other bankruptcy courts from outside the Eleventh Circuit followed its lead. See In re Hill, 222 B.R. 119, 122-23 (Bankr. N.D. Oh. 1998); In re Lovato, 203 B.R. 747, 749 (Bankr. D. Wyo. 1996); see also ***39** Behrens v. Woodhaven Ass'n, 87 B.R. 971, 976 (Bankr. N.D. Ill. 1988), aff'd, No. 83 B 4896, 1989 WL 47409 (N.D. Ill. Mar. 8, 1989) (finding willful violation of discharge order in case before In re Hardy when creditor sued debtor on a prepetition contract "with full knowledge of the Debtors' Chapter 7 case and discharge").

As Murphy concedes, fewer courts had addressed the standard for willful violations of discharge orders by 1998 than those that had discussed the meaning in the context of automatic stays and § 362(h). However, we find that when Congress enacted § 7433(e), it sought to apply the same generally accepted standard to violations of both automatic stays and discharge orders.

First, the plain language of § 7433(e) does not distinguish between the two orders. The object of the verb/adverb combination "willfully violates" in § 7433(e) is "any provision of section 362 (relating to automatic stay) or 524 (relating to effect of discharge)...." Based on this structure, it would seem odd to imbue "willfully violates" with two different meanings, one for automatic stays and one for discharge orders.

Second, preexisting provisions of the Tax Code already allowed the IRS to raise its good faith belief, not as a defense to liability, but as a means of mitigating damages. Under 26 U.S.C. § 7430, a taxpayer who "prevails" in an action against the IRS may recover reasonable attorney's fees. However, there is an exception to this rule: a taxpayer will not be treated as the prevailing party "if the United States establishes that the position of the [IRS] in the proceeding was substantially justified."

26 U.S.C. § 7430(c)(4)(B).

[11] [12]Section 7430(c)(4)(B) was already in place in 1998, see 26 U.S.C. § 7430(c)(4)(B) (West 1998), and similar protections had been in place since 1982, see 26 U.S.C. § 7430(c)(2)(A) (West 1982) (party not a prevailing party against the United States unless it "establishes that the position of the United States in the civil proceeding was unreasonable"); Kaufman v. Egger, 758 F.2d 1, 3-4 (1st Cir. 1985). As the bankruptcy court recognized below, § 7430(c)(4)(B) "acknowledges that liability under the Code may flow from good faith actions of the IRS, but that 'substantial justification' may mitigate the damages available to the aggrieved party." In re Murphy, 2013 WL 6799251, at *9 (emphasis added); see also Kovacs v. United States, 739 F.3d 1020, 1026 (7th Cir. 2014) (discussing interplay between § 7430 and § 7433(e)). While the IRS cannot rely on its good faith belief that it could collect from Murphy as a defense to liability, it can invoke its good faith belief to limit Murphy's recovery to his actual damages.[6]

[13]For the foregoing reasons, we find that "willful violation" had an established meaning in 1998 and that Congress used that established meaning in § 7433(e) to set the standard for evaluating violations of both automatic stays and discharge orders.

IV.

Although we rely primarily on Congress's contemporary understanding of the phrase "willful violation" in construing § 7433(e), post-1998 decisions from this circuit and administrative materials from the IRS confirm that the generally accepted definition of willful violation should control.

***40** Since 1998, this circuit has adopted the same definition of "willful violation" for violations of both automatic stays and discharge orders. In Fleet Mortgage Group, Inc. v. Kaneb, issued only one year after § 7433(e) was enacted, we explicitly adopted the generally accepted definition for violations of automatic stays. 196 F.3d at 268-69. Subsequently, in In re Pratt, we used the same standard to evaluate whether a violation of a discharge order was willful. 462 F.3d at 21. We stressed that Kaneb had "rejected the proposition that a stay violation could not be actionable (viz., 'willful') if the creditor had made a good faith mistake." Id. We then held that the creditor in Pratt willfully violated the discharge order because the creditor:

> ha[d] not suggested—nor could it plausibly do so on these record facts—that it did not know of the existence of the [debtors'] chapter 7 discharge, or that it did not intend to communicate to the [debtors] its refusal to release its lien in the automobile so that it could be junked.

Id.

[14]In addition, the current version of the Internal Revenue Manual appears to adopt the same generally accepted definition for violations of automatic stays and discharge orders. The Manual defines "willful" as "an act that was committed intentionally or knowingly" and states that "[a] willful violation occurs when the Service has received notice of a voluntary bankruptcy filing or of the court's granting of a discharge, and the Service does not respond timely to stop its collection activities." I.R.M. 1.4.51.2.7.1 (Aug. 11, 2015). Although the Manual does not have the force and effect of law, we may rely on it to the extent we find it persuasive. See Heinz v. Cent. Laborers' Pension Fund, 303 F.3d 802, 812 n.17 (7th Cir. 2002) (citing United States v. Mead Corp., 533 U.S. 218, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001)).

V.

We turn then to the IRS's alternative argument: that even if there was a generally accepted definition of "willful violation," such a definition is too broad to be applied against the United States because § 7433(e) is a waiver of sovereign immunity and such waivers must be narrowly construed.

[15] [16] [17]It is true that courts "construe any ambiguities in the scope of a waiver in favor of the sovereign." FAA v. Cooper, 566 U.S. 284, 291, 132 S.Ct. 1441, 182 L.Ed.2d 497 (2012). At the same time, "the sovereign immunity canon 'is a tool for interpreting the law' and ... it does not 'displac[e] the other traditional tools of statutory construction.' " Id. (quoting Richlin Sec. Serv. Co. v. Chertoff, 553 U.S. 571, 589, 128 S.Ct. 2007, 170 L.Ed.2d 960 (2008)). We thus must "be careful not to be more stinting in the interpretation of the provision than its language requires," for "just as the courts should not construe a waiver of sovereign immunity more broadly than Congress intended, '[n]either, however, should we assume the authority to narrow the waiver that Congress intended.' " Rakes v. United States, 442 F.3d 7, 19 n. 6 (1st Cir. 2006) (quoting United States v. Kubrick, 444 U.S. 111, 118, 100 S.Ct. 352, 62 L.Ed.2d 259 (1979)).

As discussed above, traditional interpretive tools lead us to conclude that the generally accepted definition of "willful violation" should apply to § 7433(e). By 1998, "willful violation" had an established meaning in the context of violations of automatic stays, and this established meaning had been applied to violations of discharge orders. And, by 1998, the Tax Code already allowed the IRS to raise its ***41** good faith belief, not as a defense to liability, but as a means of limiting the taxpayer's recovery to the actual damages incurred. Moreover, several of the decisions adopting the generally accepted definition of "willful violation" before 1998 applied that definition against the government, despite the government's invocation of sovereign immunity. See In re Hardy, 97 F.3d at 1390; In re Jove Eng'g, Inc., 92 F.3d at 1555-56; In re Price, 42 F.3d at 1071; In re Pinkstaff, 974 F.2d at 115.

[18]When considering the scope of a waiver of sovereign immunity, a "narrower temporal approach—looking at congressional understanding of the enumerated sections at the time of the [enactment]—is preferable," in part because "the approach adheres to the general principle that Congress is presumed to know the content of background law." United States v. Torres (In re Rivera Torres), 432 F.3d 20, 25 (1st Cir. 2005). By directly linking the phrase "willfully violates" in § 7433(e) to sections 362 and 524, Congress sought to use the generally accepted definition of the phrase "willful violation" in this context as the limit to its waiver of sovereign immunity. And, when we look past 1998, our subsequent caselaw and the administrative materials from the IRS itself both confirm that the generally accepted standard should control. For these reasons, we do not believe sovereign immunity requires us to adopt a more narrow definition of "willfully violates."

The IRS claims that if we apply the generally accepted definition of "willful violation" to § 7433(e), we are effectively forcing it to "seek a pre-enforcement determination from the bankruptcy court about whether a tax debt has been discharged prior to initiating any post-discharge collection efforts," which would be both impractical and inconsistent with other provisions of the Bankruptcy Code.

[19]We agree that "the IRS need not appear and object in the bankruptcy court to be excepted from [a] discharge under § 523(a)(1)(C)." Console v. Comm'r, 291 Fed.Appx. 234, 237 (11th Cir. 2008). Nothing in our decision today forces the IRS to obtain a pre-enforcement determination before seeking to collect on tax obligations like Murphy's. The IRS remains free to "wait until the bankruptcy discharge is invoked as a defense to its collection efforts, and then prove a factual basis for the tax fraud exception in the collection proceedings." Id.

But, to the extent we find policy considerations relevant, we believe compelling policy justifications, embodied in § 7433(e), weigh against allowing the IRS to attempt to collect purportedly discharged debts without facing potential consequences. Discharge orders "ensure that debtors receive a 'fresh start' and are not unfairly coerced into repaying discharged prepetition debts." In re Pratt, 462 F.3d at 19. Congress enacted § 7433(e) to protect taxpayers who invoked the bankruptcy process, providing them with a means of recovering damages if an employee of the IRS willfully violates either the automatic stay or the discharge order, the two foundational orders of the bankruptcy process.

If the IRS found the February 14, 2006 discharge order ambiguous, there was a variety of processes available to it to

determine whether Murphy's tax obligations had been discharged. First, although not obligated to, the IRS could have forestalled any possible question about dischargeability by filing an objection in the bankruptcy court after it received notice of Murphy's petition but before Murphy received his discharge. See Console, 291 Fed.Appx. at 237; see also Korte v. United States (In re Korte), 262 B.R. 464, 471 (B.A.P. 8th Cir. 2001). Second, the IRS could have filed an adversary proceeding ***42** before it began its collection efforts to obtain a determination of whether the tax obligations were covered by the discharge order. See Hassell v. Comm'r, 92 T.C.M. (CCH) 273, 2006 WL 2602032, at *3 (2006); United States v. Acker (In re Acker), No. 09-41961, 2010 WL 3547221, at *1 (Bankr. E.D. Tex. Sept. 7, 2010).

Alternatively, the IRS could, as it did, attempt to collect from Murphy and thereby force him to return to the bankruptcy court to obtain a determination that the debts had been discharged. And, of course, if AUSA Emery had adequately supported the opposition for summary judgment on dischargeability with admissible evidence back in 2010, the bankruptcy court may well have ruled in the IRS's favor and brought this case to an end years ago, with the IRS facing no penalty for its collection efforts.

Because of the parties' settlement agreement, the factual issues surrounding Murphy's alleged tax evasion and AUSA Emery's cognitive disability are no longer relevant to this case. We agree with the dissent that no judge has found that Murphy did not evade taxes, and we take seriously the allegations against Murphy that the IRS continues to make in its filings.[7]

If we were to adopt the IRS's definition, we would render § 7433(e) a near nullity. As the bankruptcy court ably described it below:

> [t]he IRS's position is that, as far as tax collection and § 523(a)(1)(C) goes, it retains the authority to make up its mind whether tax obligations are discharged, that it may act unilaterally on the basis of its conclusions, and that it encounters no risk for doing so, as long as it has a "good faith" or "reasonable belief" for its conclusion.

In re Murphy, 2013 WL 6799251, at *6.

Under this view, it is hard to imagine a case where a taxpayer could ever collect against the government for a violation of the automatic stay or discharge order. Although the dissent forcefully argues that the sovereign immunity canon compels this narrow definition of "willfully violates," we ultimately find that the dissent's position "presents an unduly restrictiv[e] reading of the congressional waiver of sovereign immunity, rather than a realistic assessment of legislative intent." Franconia Assocs. v. United States, 536 U.S. 129, 145, 122 S.Ct. 1993, 153 L.Ed.2d 132 (2002) (alteration in original) (internal quotation marks and citations omitted).

VI.

The IRS had several opportunities to obtain a judicial determination that Murphy's tax obligations were excepted from discharge. The bankruptcy court determined, based on the evidence presented to it, that Murphy's tax obligations were not excepted from discharge. In such cases where a taxpayer's debt is found to be discharged, Congress has allowed the taxpayer to pursue an action against the United ***43** States under § 7433(e) if an employee of the IRS knew of the discharge order and took an intentional action that violated the order.

For the foregoing reasons, we affirm.

LYNCH, Circuit Judge, dissenting.

With the greatest respect for my esteemed colleagues, I think the majority gets this one wrong. To the best of my knowledge, this is the first opinion by a circuit court of appeals construing the phrase "willfully violates" in 26 U.S.C. § 7433(e), enacted in 1998, and, importantly, the first to deprive the United States, through the IRS, of its sovereign immunity under that statute even where the United States acted on a reasonable and good faith belief that a discharge injunction did not apply to its collection efforts against a tax debtor.

To be clear, there is no explicit waiver by Congress of sovereign immunity under these circumstances. The majority attempts to infer such a waiver. To the contrary, the Bankruptcy Code itself provides that a discharge injunction does not apply to a tax debt "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." 11 U.S.C. § 523(a)(1)(C). And the IRS here says it believed in good faith that the tax debts it attempted to collect fell into this exception.

Further, the plain meaning of the phrase "willfully violates," Supreme Court precedent interpreting the term "willful" and the phrase "willful violation," the structure of the statutory scheme, and the sovereign immunity canon all point toward § 7433(e) not stripping the IRS of a reasonable good faith defense. Because the majority opinion deprives the United States of sovereign immunity and does so for reasons which I conclude are inconsistent with Congressional intent, Supreme Court precedent, and with rules of construction, I lay out the basis for my dissent.

A. Sovereign Immunity

Sovereign immunity is waived only if Congress clearly intended as much. See F.A.A. v. Cooper, 566 U.S. 284, 290, 132 S.Ct. 1441, 182 L.Ed.2d 497 (2012). "A waiver of sovereign immunity 'cannot be implied but must be unequivocally expressed.' " Irwin v. Dep't of Veterans Affairs, 498 U.S. 89, 95, 111 S.Ct. 453, 112 L.Ed.2d 435 (1990) (quoting United States v. Mitchell, 445 U.S. 535, 538, 100 S.Ct. 1349, 63 L.Ed.2d 607 (1980)).

"[A]ny ambiguities in the scope of a waiver" are to be construed "in favor of the sovereign." Cooper, 566 U.S. at 291, 132 S.Ct. 1441. "Ambiguity exists if there is a plausible interpretation of the statute that would not authorize money damages against the Government." Id. at 290-91, 132 S.Ct. 1441. Consequently, we must determine whether § 7433(e) can be plausibly interpreted not to authorize money damages against the United States where the IRS acted reasonably and in good faith to collect a tax debt. The statute can and should be so interpreted. In my view, such an interpretation is far more than plausible.

There is no expression by Congress here of a waiver of sovereign immunity where the IRS acts reasonably and in good faith to collect tax debts it reasonably believes do not fall within the scope of a discharge injunction. When Congress intends to waive sovereign immunity, it knows how to do so explicitly. See, e.g., 11 U.S.C. § 106(a) ("Notwithstanding an assertion of sovereign immunity, sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to the following [enumerated provisions of ***44** the Bankruptcy Code]."); 26 U.S.C. 7433(a) (creating a cause of action for damages against the United States "[i]f, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title"). Congress did not do so here and it easily could have.[8]

B. Text of 26 U.S.C. § 7433(e)

As a matter of statutory construction, we must first look the text of § 7433(e). See SAS Inst., Inc. v. Iancu, —— U.S. ——, 138 S.Ct. 1348, 1354, 200 L.Ed.2d 695 (2018); Mississippi ex rel. Hood v. AU Optronics Corp., 571 U.S. 161, 168, 134 S.Ct. 736, 187 L.Ed.2d 654 (2014). Section 7433(e) states that, "[i]f, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the [IRS] willfully violates any provision of section 362 ... or 524 ... of title 11 ...[,] such taxpayer may petition the bankruptcy court to recover damages against the United States." (emphasis added).

This case turns on how we interpret the phrase "willfully violates." "Willfully" modifies "violates," and the ordinary meaning of "willful," which controls where the term is not defined in the statute, see Octane Fitness, LLC v. ICON Health & Fitness, Inc., —— U.S. ——, 134 S.Ct. 1749, 1756, 188 L.Ed.2d 816 (2014), is "deliberate" or "on purpose." E.g., Wilful, Oxford English Dictionary Online, http://www.oed.com/view/Entry/229028 (last visited May 25, 2018) ("Done on purpose or wittingly; purposed, deliberate, intentional; not accidental or casual. Chiefly, now always, in bad sense, of an action either evil in itself or blameworthy in the particular case" (emphasis added)); Willful, Merriam-Webster's Dictionary Online, https://www.merriam-webster.com/dictionary/willful (last visited May 25, 2018) ("done deliberately"). So the IRS has to deliberately violate a discharge injunction to be liable under § 7433(e).

Applying these definitions of "willful" here, the statute should (and certainly can plausibly) be read to provide the United States with a good faith defense. "Willfully" requires that the violation be done "deliberately" or "knowingly." In this case, that would mean an IRS employee must have violated the discharge injunction deliberately, with knowledge that he was violating the injunction.[9]

Under other provisions of the Bankruptcy Code, no creditor, whether the IRS or another, necessarily violates a discharge injunction merely by trying to collect a debt while aware of the injunction. See, e.g., ***45** United States v. Ellsworth (In re Ellsworth), 158 B.R. 856, 858 (Bankr. M.D. Fl. 1993). Rather, a discharge injunction is violated only if the particular debt that the creditor is trying to collect was actually discharged as a result of the injunction. But IRS debts receive special treatment. Section 523(a) lists several types of debts that are not dischargeable, and that list includes tax debts "with respect to which the debtor ... willfully attempted ... to evade or defeat such tax." When the IRS, knowing of a discharge injunction, makes tax debt collection efforts, and it has reasonably and in good faith, even if erroneously, determined that the tax debt was not dischargeable and thus was not covered by the discharge injunction, the IRS's "violation" was not done deliberately merely because its assessment of the effect of the injunction was incorrect.

No judge in this case has even held that the debtor did not in fact make "a fraudulent return or willfully attempt in any manner to evade or defeat such tax." Id. § 523(a)(1)(C). At most, the initial bankruptcy judge held that the IRS attorney (who the IRS maintains had been made incompetent by the onset of dementia) did not "present [the] evidentiary quality material" required to prove tax fraud. The IRS also maintains that the disabled attorney also did not give notice to the IRS of his actions in the case, leaving the IRS unaware of his incapacity and his failure to provide adequate evidence. The extent and timing of the attorney's disability is relevant to whether an IRS employee "willfully violate[d]" the discharge injunction under the plain meaning of that phrase. Yet the majority's holding would render these factors irrelevant.

C. Pre-Section-7433(e) Case Law

1. Supreme Court Precedent

The majority reasons that the key to this case is found in the premise that Congress is presumed to know how the law has been interpreted by the courts, and then to legislate against that backdrop. See Hood, 571 U.S. at 169, 134 S.Ct. 736; Bragdon v. Abbott, 524 U.S. 624, 644-45, 118 S.Ct. 2196, 141 L.Ed.2d 540 (1998).

The majority, though, in my view, misapplies the premise. I disagree that we should interpret § 7433(e) based on how some circuit courts had interpreted the phrase "willful violation" in the context of a different and older statute, 11 U.S.C. § 362(h). We cannot ignore the decades of Supreme Court case law interpreting the term "willful" and the phrase "willful violation." Congress, after all, did not simply say "violates"; § 7433(e) modifies and restricts the word "violates" with the word "willful."

If we are to "presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts," Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 185, 108 S.Ct. 1704, 100 L.Ed.2d 158 (1988), then we should presume here that Congress knew about clearly established Supreme Court precedent. I would have thought that Supreme Court law would be far more relevant than the general and not uniform pronouncement of some circuits.

Congress would have been particularly aware of how the Supreme Court interpreted the term "willful" in Kawaauhau v. Geiger, 523 U.S. 57, 118 S.Ct. 974, 140 L.Ed.2d 90 (1998), which was decided just months before § 7433(e) was passed. Kawaauhau was a natural place to look: it pertained to 11 U.S.C. § 523, a part of the Bankruptcy Code that lists the types of debts that cannot be discharged. See Kawaauhau, 523 U.S. at 59, 118 S.Ct. 974. Section 523 is a statute of intrinsic importance when determining whether a discharge injunction was willfully violated. In Kawaauhau, the Court determined that ***46** "willful ... injury" included only acts that were specifically intended to cause injury, not all intentional acts that resulted in injury. 523 U.S. at 61, 118 S.Ct. 974. The Court explained its holding as follows:

> The word "willful" ... modifies the word "injury," indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury. Had Congress meant to exempt debts resulting from unintentionally inflicted injuries, it might have described instead "willful acts that cause injury." Or, Congress might have selected an additional word or words, i.e., "reckless" or "negligent," to modify "injury."

Id. That logic maps directly onto the language of § 7433(e). "Willfully" modifies "violates," so liability requires a deliberate or intentional "violation." Had Congress intended otherwise, it would have said so clearly. We should assume Congress knew about this latest Supreme Court interpretation of similar language in the bankruptcy context when it was drafting § 7433(e).

Moreover, the Supreme Court, consistent with Kawaauhau, had long held that "willful violation" requires that the violator "knew or showed reckless disregard for the matter of whether its conduct was prohibited." Trans World Airlines, Inc. v. Thurston, 469 U.S. 111, 128-29, 105 S.Ct. 613, 83 L.Ed.2d 523 (1985). The Supreme Court, before § 7433(e) was enacted, also had repeatedly held that the term "willful" requires more than negligence. See Bryan v. United States, 524 U.S. 184, 196, 118 S.Ct. 1939, 141 L.Ed.2d 197 (1998) (holding that a criminal statute's use of "willful" required "knowledge that the conduct is unlawful"); McLaughlin v. Richland Shoe Co., 486 U.S. 128, 133, 108 S.Ct. 1677, 100 L.Ed.2d 115 (1988) ("The word 'willful' is widely used in the law, and ... is generally understood to refer to conduct that is not merely negligent."); United States v. Ill. Cent. R. Co., 303 U.S. 239, 243, 58 S.Ct. 533, 82 L.Ed. 773 (1938) (holding that "[w]illfully ... means purposely or obstinately and is designed to describe the attitude of a carrier, who, having a free will or choice, either intentionally disregards the statute or is plainly indifferent to its requirements." (quoting St. Louis & S.F.R. Co. v. United States, 169 F. 69, 71 (8th Cir. 1909))); United States v. Murdock, 290 U.S. 389, 395, 54 S.Ct. 223, 78 L.Ed. 381 (1933) ("The word ["willfully"] is ... employed to characterize a thing done without ground for believing it is lawful, or conduct marked by careless disregard whether or not one has the right so to act." (citations omitted)). These cases[10] mean that the phrase "willfully violates" in § 7433(e) certainly requires more than mere knowledge of a discharge injunction in order to have a violation of that injunction, especially when the IRS has a reasonable good faith belief that the injunction does not apply.

2. Circuit Precedent Was Neither Clear nor Unanimous

Even if we could look at circuit and bankruptcy court interpretations of other statutes, 11 U.S.C. §§ 362(h) and 524, to interpret the phrase "willfully violates," the definition of that phrase must have been clearly established and "settled" at the time § 7433(e) was enacted in order for the majority's argument to succeed. ***47** Armstrong v. Exceptional Child Ctr., Inc., —— U.S. ——, 135 S.Ct. 1378, 1386, 191 L.Ed.2d 471 (2015) (declining to apply the prior-construction canon because, inter alia, the courts' interpretation of the pre-existing statutory provision was not "settled" (quoting Bragdon, 524 U.S. at 645, 118 S.Ct. 2196)); see also United States v. Torres (In re Rivera Torres), 432 F.3d 20, 26 (1st Cir. 2005).

The Supreme Court has only applied a judicial interpretation of a pre-existing statute to a new statute where that interpretation was unanimous or very close to it. See Bragdon, 524 U.S. at 644-45, 118 S.Ct. 2196 (holding that, because "[e]very court" that had interpreted the preexisting statute was in agreement, "the new statute should be construed in light of this unwavering line of administrative and judicial interpretation" (emphasis added)); Lorillard v. Pons, 434 U.S. 575, 580, 98 S.Ct. 866, 55 L.Ed.2d 40 (1978) (applying the prior-construction canon where "every court" to interpret the pre-existing statute had been in agreement).

I do not see the pre-§ 7433(e) consensus among those courts that the majority does. Before the enactment of § 7433(e), seven circuits had stated that the phrase "willful violation" in § 362(h), which concerns stays of collection activity once a debtor files for bankruptcy, applied whenever a creditor knew of an automatic stay and violated it.[11] However, three circuits had held that more was required in order for the violation of the stay to be "willful." Seven out of ten is a circuit split, not a clear consensus.[12] And a stay is not a discharge injunction, and "creditor" encompasses far more than the IRS.

As I read the law of the First Circuit, it specifically allowed for reasonable good faith as a defense to a claimed willful violation of a stay. See Nelson v. Taglienti (In re Nelson), 994 F.2d 42, 45 (1st Cir. 1993); see also Vahlsing v. Commercial Union Ins. Co., 928 F.2d 486, 490 (1st Cir. 1991). In Vahlsing, this court noted that "[v]iolation of [a] stay ... is not a strict liability tort." 928 F.2d at 490. In In re Nelson, this court went further, holding that a bankruptcy stay was not willfully violated because, inter alia, "it was reasonable for [the creditor] to believe that the property was not part of the bankruptcy estate." 994 F.2d at 45. In re Nelson was still controlling law when § 7433(e) was enacted in 1998.

***48** Other circuits had also held that a colorable legal argument of no violation was sufficient to show that a violation of an automatic stay was not willful. The Fifth Circuit had held that a creditor did not "willfully violate[ ] the automatic stay" because her legal position that the stay did not apply was "arguable." Matter of Sherk (In re Sherk), 918 F.2d 1170, 1178 (5th Cir. 1990) abrogated on other grounds by Taylor v. Freeland & Kronz, 503 U.S. 638, 643, 112 S.Ct. 1644, 118 L.Ed.2d 280 (1992). The Sixth Circuit took a similar position in Andrews University v. Merchant (In re Merchant), 958 F.2d 738 (6th Cir. 1992), finding that a university's violation of an automatic stay "was not willful" without holding that the university did not know of the stay. Id. at 740, 742.

The majority posits that Congress would have ignored these three circuit court opinions when drafting § 7433(e), but provides no credible reason why.[13] The majority dismisses these cases as "limited resolutions of idiosyncratic fact patterns," but the holdings on these fact patterns establish the very point that proves the majority wrong. When § 7433(e) was passed in 1998, three circuits had held that a colorable legal position was sufficient to show that a violation of a stay was not willful. These decisions never said that their interpretation of "willful violation" in § 362(h) was affected by the unusual nature of the facts presented. Bankruptcy cases—including this one—often involve unusual facts; the peculiarity of the facts in a couple of the cases involved in the pre-1998 circuit split does not mean that Congress would have interpreted those cases differently or seen a consensus where there was none. The majority argues that In re Nelson was limited to its facts but, even if that were true, its holding that a reasonable legal argument was sufficient to render a violation not willful is irreconcilable with the

majority's holding in this case.

D. Congress's Tax Collection Scheme Is Inconsistent with the Majority View

The statutory context for the IRS tax collection scheme, which we are required to consider, see SAS Inst., 138 S.Ct. at 1355, is also inconsistent with the majority view. I am concerned that that majority holding will cause damage to the tax collection scheme. The practical effect of the decision is to impose damages on the IRS when it initiates collection efforts in the face of a discharge injunction that the IRS reasonably and in good faith determines does not apply. The opinion effectively requires the IRS to first go to court and prove its case that the taxes are owed before instituting any collection efforts. But Congress has decided to the contrary.

Congress specifically chose not to require the IRS to first obtain a judicial ***49** determination that an exception to discharge applies before engaging in tax debt collection efforts. Section 523(a) holds that certain types of debts, including tax debts "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax,"[14] are excepted from a discharge injunction. Id. § 523(a)(1)(C). By contrast, § 523(c)(1) specifies that three particular types of debts are automatically deemed included in a discharge injunction unless or until the creditor initiates a post-injunction adversarial proceeding that yields a judicial determination that the debt is excepted from discharge. Significantly, tax debts are not listed in § 523(c)(1). This means that Congress chose not to require that the IRS seek a pre-collection determination from the bankruptcy court that tax debts are excepted from a discharge injunction. Given that Congress created this exception to discharge and did not require the IRS to seek a pre-collection determination that tax debts are not dischargeable, there is no reason to say that the IRS should incur the risk of having damages found against it even if it acted on a reasonable and good faith belief that the tax debts were excepted from discharge.[15]

If Congress had intended to require the IRS to seek a pre-collection determination from the bankruptcy court or had intended for the IRS to incur a risk of damages under these circumstances even when it acts reasonably, it would have said so directly. Epic Sys. Corp. v. Lewis, —— U.S. ——, 138 S.Ct. 1612, —— L.Ed.2d ——, 2018 WL 2292444 (2018) ("Congress 'does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.' " (quoting Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 468, 121 S.Ct. 903, 149 L.Ed.2d 1 (2001))). Yet the majority has, in effect, imposed such a requirement. In doing so, the majority reaches a result that Congress contemplated and explicitly rejected.

I also disagree with the majority's argument that the existence of 26 U.S.C. § 7430(c)(4)(B) in 1998 shows that Congress intended for § 7433(e) to waive sovereign immunity even where the IRS has a reasonable and good faith belief that the debt was not discharged. Section 7430 is concerned with an altogether different topic. It allows a "prevailing party" in litigation against the IRS to recover "reasonable litigation costs incurred in connection with such court proceeding," under certain circumstances. Id. at § 7430(a)(2). And even under § 7430, a victorious taxpayer is not treated as a "prevailing party," and so is unable to recover litigation costs against the IRS, if the IRS's litigation position was "substantially justified." Id. at § 7430(c)(4)(B).

Contrary to the majority's assertion, the IRS cannot mitigate the damages it is ***50** forced to pay to the taxpayer under the majority's interpretation of § 7433(e) by showing a substantial justification for its position under § 7430(c)(4)(B). Section 7430 only covers "litigation and administrative costs," so having a substantially justified position does not allow the IRS to mitigate the § 7433(e) damages the majority would force it to pay. Parties are routinely required to cover their own costs; § 7430's cost-shifting provision has no bearing on § 7433(e) damages.

It is not true, as the majority posits, that adopting the IRS's definition of "willfully violates" "would render § 7433(e) a near nullity." Adopting the IRS's definition would only free it to collect tax debts that it reasonably believes are not covered by a

discharge injunction or automatic stay. If the IRS were to collect other types of tax debts not exempted from discharge by § 523, that would present a different issue under § 7433(e), which is not before us.

The majority appears skeptical that courts would ever find that the IRS has violated the reasonableness requirement. Several bodies of law instruct courts to inquire into the reasonableness of an actor's behavior, including torts, see, e.g., Restatement (Second) of Torts § 282 (1965), and administrative law, see, e.g., Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 844, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). The use of a reasonableness standard in those areas does not render the relevant statutes near nullities.

In my view, the intent of Congress is clearly not to waive sovereign immunity in these circumstances. But even if there were ambiguity, that ambiguity itself would require that we find no waiver of sovereign immunity. I respectfully dissent.

All Citations

892 F.3d 29, 121 A.F.T.R.2d 2018-1996, 2018-1 USTC P 50,280, 65 Bankr.Ct.Dec. 195

Footnotes

[*] Hon. David H. Souter, Associate Justice (Ret.) of the Supreme Court of the United States, sitting by designation.

[1] Prior to filing his complaint, Murphy exhausted his administrative remedies as required by 26 U.S.C. § 7433(1).

[2] Section 7433(e) allows a debtor "to recover damages against the United States." (emphasis added). As the district court noted in its September 7, 2016 decision, it appears that the United States, and not the IRS, "is the real party in interest" in this case. Murphy, 564 B.R. at 98 n.1. "Like the appellant's brief, however, for simplicity" we will refer "to the appellant as 'the IRS.' " Id.

[3] A similar provision can be found today at 11 U.S.C. § 362(k)(1).

[4] As Murphy correctly notes in his brief, when we later adopted the generally accepted definition of "willful violation" for violations of automatic stays in Fleet Mortgage Group, Inc. v. Kaneb, we did not reference any departure from our prior precedent. In fact, we adopted the generally accepted definition because we "decline[d] to create a new standard for willfulness." Fleet Mortg. Grp., Inc., 196 F.3d at 268.

[5] One judge dissented from this part of In re University Medical Center, stating that he would have found a willful violation of the automatic stay because the Third Circuit had already "explicitly rejected good faith as a defense to 'willfulness.' " 973 F.2d at 1089 (Becker, J., concurring in part and dissenting in part).

[6] In this case, the IRS has stipulated to the amount of damages as a part of the settlement agreement.

[7] Based on the odd procedural history of this case, no factfinder has yet resolved whether AUSA Emery's disability caused him to file the deficient opposition to summary judgment. The district court's 2016 order remanded the case back to the bankruptcy court in part so the bankruptcy court could resolve these issues and thereby determine whether application of offensive collateral estoppel against the IRS was proper. Murphy, 564 B.R. at 111-12. Ultimately, the parties left the issue open in their settlement, in part because of "the desire to avoid not only their respective risk of loss on the determination of whether offensive collateral estoppel should apply, but also the potential for the determination to entail substantial litigating expenses (including possible expert medical testimony) and substantial delay."

[8] Franconia Assocs. v. United States, 536 U.S. 129, 122 S.Ct. 1993, 153 L.Ed.2d 132 (2002), is cited by the majority, but it has nothing to do with the issues presented here. The limitation principle referred to there was not about sovereign immunity at all, but about whether a special accrual rule from a statute of limitations should be carved out for the government when there is a repudiation of a Farmer's Home Administration loan contract. See id. at 145, 122 S.Ct. 1993. It is true that Franconia cites to language about sovereign immunity in two other cases, but once again those cases assist the dissent. Irwin involved an explicit statutory waiver of immunity and the question presented was whether the doctrine of equitable tolling fell within that exception. 498 U.S. at 95, 111 S.Ct. 453. The same is true of the question presented in Bowen v. City of New York, 476 U.S. 467, 106 S.Ct.

2022, 90 L.Ed.2d 462 (1986), where Congress had explicitly waived sovereign immunity as to certain social security suits and the issue was whether the waiver included recognition of the equitable tolling doctrine. See id. at 479-80, 106 S.Ct. 2022.

9 There is no claim the IRS acted recklessly.

10 The Supreme Court in Safeco Ins. Co. of Am. v. Burr, 551 U.S. 47, 127 S.Ct. 2201, 167 L.Ed.2d 1045 (2007), stated that "where willfulness is a statutory condition of civil liability," that term typically covers "knowing" and "reckless" violations. Id. at 57, 127 S.Ct. 2201.

11 The majority also references Hardy v. IRS, (In re Hardy), 97 F.3d 1384 (11th Cir. 1996), which interpreted the phrase "willful violation" in the § 524 context. That case is of little help because it was the only circuit case addressing that definition in the § 524 context when § 7433(e) was passed, meaning the § 524 case law was not "clearly established." In re Rivera Torres, 432 F.3d at 26.

12 In order to support its argument that Congress would have understood "willfully violates" to cover situations where the IRS acted reasonably and in good faith, the majority looks to circuit case law post-dating the enactment of § 7433(e). Cases from the 2000s do not help us determine how Congress would have understood a phrase in 1998. Even so, there is no consensus on the definition of "willful" in the § 524 discharge injunction context. The Ninth Circuit has held that a good faith belief that one is not violating a discharge injunction is sufficient to show that there was no "willful violation" of the discharge injunction. See Lorenzen v. Taggert (In re Taggert), 888 F.3d 438, 444 (9th Cir. 2018). Indeed, the Ninth Circuit does not even impose a reasonableness requirement. Id. ("the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable" (emphasis added) (citing Corning v. Corning (In re Zilog, Inc.), 450 F.3d 996, 1009 n.14 (9th Cir. 2006))).
The same is true of the majority's reference to the Internal Revenue Manual. A citation to the current Manual does not tell us how Congress would have interpreted "willfully violates" in 1998. As the majority concedes, the Manual does not even have the force of law.

13 The majority attempts to deny the existence of this circuit split by pointing to a handful of lower and Article I court cases that are not in accordance with the precedent of their respective circuits. These cannot minimize the circuit split. The First, Fifth, and Sixth Circuits had held that mere knowledge of a stay was insufficient to show a "willful violation."
The majority similarly argues that Congress would have ignored these cases when drafting § 7433(e) because they lack "a broader analysis of the meaning of 'willful violation.' " First, many of the circuit cases adopting the majority's favored definition of "willful violation" also provide little analysis. See, e.g., Price v. United States (In re Price), 42 F.3d 1068, 1071 (7th Cir. 1994); Goichman v. Bloom (In re Bloom), 875 F.2d 224, 227 (9th Cir. 1989). Second, that the analysis may have been limited in these three cases is irrelevant. Three circuits had held that a colorable legal argument was sufficient to show that a violation was not "willful" under § 362(h). That is enough to find that the meaning of "willful violation" was not clearly established, regardless of how much analysis the three circuits provided.

14 The issue of dischargeability of debts resulting from a debtor's dishonesty is important, as evidenced by the grant of certiorari in Appling v. Lamar, Archer & Cofrin, LLP (In re Appling), 848 F.3d 953 (11th Cir. 2017), cert. granted, —— U.S. ——, 138 S.Ct. 734, 199 L.Ed.2d 601 (Jan. 12, 2018) (No. 16-1215). See id. at 955 (holding that a debt was not excepted from discharge under § 523(a)(2) because the debtor's misrepresentation about a future cash flow amounted to a misrepresentation about his financial condition and was not made in writing).

15 The majority argues that Congress clearly used the phrase "willfully violates" in order to "directly link" § 7433(e) to the "willful violation" standard used in § 362(h). But the phrase "willfully violates" relates just as directly to Supreme Court precedent interpreting similar phrases. In any case, a "direct link" to the standard used for § 362(h) is only helpful to the majority to the extent there was a consensus around that standard when § 7433(e) was passed, and there was none.

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First Circuit Splits with the Ninth over Good Faith Defense to Discharge Violation

"Seven weeks apart, two circuits reach diametrically different conclusions about good faith as a defense to an intentional act that violates the discharge injunction."

Over a comprehensive dissent, the First Circuit ruled that the Internal Revenue Service intentionally violates the discharge injunction when an IRS employee knows there was a discharge but nonetheless "takes an intentional action" later found to violate the discharge, even if the IRS had a good faith belief that its action did not violate the discharge.

The First Circuit's June 7 opinion represents a stark split with a decision handed down by the Ninth Circuit less than seven weeks ago: *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018), petition for panel rehearing and rehearing *en banc* filed June 6, 2018. Although the First Circuit dissent cited *Taggart*, the majority did not.

The First Circuit's dissent underscores an arguably longstanding circuit split on the question of whether good faith is a defense to an alleged violation of the discharge injunction.

The majority opinion for the First Circuit, holding that good faith is not a defense to contempt, was written by Circuit Judge Norman H. Stahl. Joining the majority opinion was retired Supreme Court Associate Justice David H. Souter, sitting by designation. The dissent was by Circuit Judge Sandra L. Lynch.

The Facts in the First Circuit

The debtor filed a chapter 7 petition and received a discharge. The IRS was aware of the discharge.

Among his $600,000 in total debt, the debtor owed the IRS about $550,000 in taxes. The IRS had a good faith basis for believing that the taxes were not dischargeable under Section 523(a)(1)(C) because the debtor, allegedly, had willfully attempted to evade payment of the taxes. The IRS therefore took the position that the tax debt was not automatically discharged under Section 523(c)(1). Thus, the IRS did not object to the dischargeability of the debt before the debtor received his general discharge.

After entry of the general discharge, the IRS repeatedly notified the debtor of its belief that the taxes were not automatically discharged. After the IRS eventually levied against an account receivable owing to the debtor, he filed an adversary proceeding in bankruptcy court seeking a declaration that the debt indeed had been discharged. Allegedly because of mental infirmities afflicting the assistant U.S. Attorney (AUSA) who represented the IRS, the government presented insufficient evidence, leading the bankruptcy judge to grant summary judgment declaring that the taxes were discharged. The IRS did not appeal the ruling that the debt was discharged.

The debtor later filed a complaint against the IRS under 26 U.S.C. § 7433(e), seeking sanctions for willful violation of the discharge injunction by issuing levies against his assets. In defense, the IRS argued there was no willful violation because the government reasonably believed that the debt was not discharged.

The bankruptcy judge found a willful violation and ruled in favor of the debtor. On appeal, the district court remanded for the bankruptcy court to consider the AUSA's mental impairment.

On remand, the IRS and the debtor reached a partial settlement narrowing the issues. To avoid extensive litigation over the AUSA's mental impairment and whether his impairment would give the government a defense, the IRS agreed that the debtor could have $175,000 in damages if an appellate court ultimately were to rule that a reasonable belief that the debt was excepted from discharge was not a defense to contempt.

The bankruptcy court decided that good faith was not a defense and ruled against the IRS. The district court affirmed, and the IRS appealed.

The Majority Opinion

Given the stipulation limiting the issue on appeal, Judge Stahl said the appeals court would decide whether the IRS's good faith belief meant there was no willful violation of the discharge injunction under Section 7433(e).

Adopted in 1998, Section 7433(e) allows a taxpayer to recover damages from the U.S. if the IRS, in connection with the collection of taxes, "willfully violates any provision of" the automatic stay under Section 362 of the Bankruptcy Code or Section 524 and its injunction barring the collection of discharged debt.

Judge Stahl said that the statute defines neither "willfully" nor the phrase "willfully violates." To find a meaning for the terms, he surveyed the definition given those words by the circuit courts when the statute was adopted in 1998.

Although the dissenter disagreed about unanimity among the courts of appeals, Judge Stahl said that the circuit courts agreed that the "phrase 'willful violation' had an established meaning in the context of violations of the automatic stays [*sic*] as of 1998: a creditor willfully violated the automatic stay if it knew of the automatic stay and took an intentional action that violated the automatic stay. A good faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful."

Judge Stahl next concluded that Congress intended to give the same meaning to violations of the discharge injunction, in part because "the plain language of Section 7433(e) does not distinguish between" violations of the automatic stay and discharge.

Although Judge Stahl said he was relying "primarily" on what Congress understood "willful violation" to mean in 1998 on adopting Section 7433(e), he said that later First Circuit decisions hewed to the same definition for violations of both the automatic stay and the discharge injunction.

Although the dissenter disagreed, Judge Stahl said that his definition of "willful violation" did not entail an overbroad interpretation of the wavier of sovereign immunity in Section 7433(e).

The IRS contended that Judge Stahl's interpretation would force the government to seek a declaration about the dischargeability of debts for tax fraud, even though Section 523(a)(1)(C) excepts them from discharge automatically.

Judge Stahl rejected the argument, finding "policy considerations" against "allowing the IRS to attempt to collect purportedly discharged debts without facing potential consequences." He said the IRS had several alternatives.

First, the IRS could have filed an objection to the dischargeability of the debt, although it was not required to do so before the entry of the general discharge. Second, the IRS could have filed an adversary proceeding and sought a declaration about dischargeability before beginning collection activity.

Third, the IRS could have attempted to collect the debt, as it had done in the case at bar, and gamble that the bankruptcy court would find for the government and rule that the taxes were not discharged.

The Dissent

In dissent, Judge Lynch said that her panel was handing down the first circuit court opinion construing "willfully violates" in Section 7433(e). The majority, she said, "gets this one wrong."

Judge Lynch said her circuit was the first to deprive the government of sovereign immunity when acting "on a reasonable and good faith belief." In Section 7433(e), she found no indication of a waiver of immunity "where the IRS acts reasonably and in good faith," even if the belief turns out to be erroneous.

Rather than following circuit law, Judge Lynch would have adopted the approach of the Supreme Court where she said the justices held in the context of Section 523 that a willful injury includes only acts that "were specifically intended to cause injury, not all intentional acts that resulted in injury."

Of special significance, Judge Lynch disagreed with the majority's statement that the circuits were in agreement before 1998. Although the majority opinion reflected the holding of seven circuits, she said that the First, Fifth and Sixth Circuits would allow a good faith defense to an alleged willful stay violation. Where she said the "majority attempts to deny the existence of this circuit split," Judge Lynch said that those three circuits "had held that the mere knowledge of a stay was insufficient to show a 'willful violation.'"

In addition to older authority from those three circuits, she cited *Taggart*, decided by the Ninth Circuit on April 23. She read the Ninth Circuit as allowing a good faith defense. "Indeed," she said, "the Ninth Circuit does not even impose a reasonableness requirement." For ABI's discussion of *Taggart*, click here.

Judge Lynch placed significant reliance on Section 523(a)(1)(C), which does not "require the IRS to first obtain a judicial determination that an exception to discharge applies." The subsection, she said, "means that Congress chose not to require that the IRS seek a pre-collection determination from the bankruptcy court." [Emphasis in original.]

"Given that Congress created this exception to discharge and did not require the IRS to seek a pre-collection determination that the tax debts are not dischargeable, there is no reason to say that the IRS should incur the risk of having damages found against it even if it acted on a reasonable and good faith belief," Judge Lynch said.

Are There Grounds for *Certiorari*?

The First Circuit's decision and *Taggart* are very much at odds. The Ninth Circuit permits a good faith defense to a discharge violation, while the First Circuit does not.

Should the losing parties in either circuit petition for *certiorari*, they surely will claim there is a circuit split. However, the majority on the First Circuit found no circuit split, although the dissenter did.

By ruling on Section 7433(e), the First Circuit was not construing the same statute as the Ninth. If a *certiorari* petition is based on divergent opinions by the two circuits just seven weeks apart, the justices might shy away from granting the petition because the underlying statutes are not the same.

However, there surely is a lack of clarity about the availability of a good faith defense when a panel of the First Circuit cannot agree on whether there is a circuit split. The Supreme Court might decline to grant *certiorari* until there is a decision more starkly raising a circuit split. *Taggart* might become a better vehicle for *certiorari* after the Ninth Circuit disposes of the pending petition for rehearing and rehearing *en banc*.

Although the dissent in the First Circuit says there is a circuit split about the good faith defense generally, the dissenter also said her panel was the first appeals court to rule on Section 7433(e). Even though the underlying issue is applicable to Sections 362 and 524 of

the Bankruptcy Code, the Supreme Court might not be inclined to grant *certiorari* to the First Circuit and review the first decision on Section 7433(e).

All things considered, *Taggart* therefore might be the better vehicle for *certiorari*. The debtor in *Taggart* contends that the Ninth Circuit's opinion represents a split with the Fourth and Eleventh Circuits on the availability of a good faith defense.

If there is a petition for *certiorari* in *Taggart*, the Supreme Court may request the opinion of the U.S. Solicitor General on whether to grant or deny the petition, known as a CVSG for "consider the views of the Solicitor General." A CVSG would allow the government to weigh in on the existence of a split (or not) and presumably urge the justices to review the case.

Given the outcome in the First Circuit, the government well may urge a grant of *certiorari* in *Taggart*, especially if *certiorari* to the First Circuit is less likely.

Either case would enable the Supreme Court to rule on a fundamental, recurring issue in bankruptcy law: Does good faith allow a creditor to escape the consequences of an intentional violation of the principal relief a debtor obtains through bankruptcy?

Opinion Link:	Opinion Link
Judge Name:	Norman H. Stahl, David H. Souter, Sandra L. Lynch
Case Citation:	IRS v. Murphy, 17-1601 (1st Cir. June 7, 2018)
Case Name:	IRS v. Murphy
Case Type:	Consumer
Court:	1st Circuit
Bankruptcy Tags:	Consumer Bankruptcy Discharge/Dischargeability Bankruptcy Taxation Govt. Claims/Sovereign Immunity

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By The Numbers

Total cases in system : 923

Business Cases : 340

Consumer Cases : 402

Circuit Splits Cases : 40

Supreme Court Cases : 55

Total Judges : 552

5. JUDGE DANIEL COLLINS

Topic: Under what circumstances may a consumer debtor's lawyer bifurcate a fee agreement to pre and post payment of fees? This ties to a recent Dan Garrison article which appeared in the June 2018 ABI Journal.

Walton v. Clark & Washington, P.C., 469 B.R. 383 (2012)
23 Fla. L. Weekly Fed. B 307, 23 Fla. L. Weekly Fed. B 339

469 B.R. 383
United States Bankruptcy Court,
M.D. Florida,
Tampa Division.

In re Donald F. WALTON, United States Trustee for Region 21, Plaintiff,
v.
CLARK & WASHINGTON, P.C., Defendant.

No. 8:09–mp–00010–MGW.
|
May 21, 2012.

Synopsis

Background: United States Trustee (UST) filed miscellaneous proceeding against law firm that represented individual debtors in consumer cases under Chapter 7 and Chapter 13, seeking declaration that firm's fee arrangement, which involved firm's receipt and deposit of postdated checks, violated automatic stay and discharge injunction, and also created conflict of interest between firm and its clients. The Bankruptcy Court, Michael G. Williamson, J., 454 B.R. 537, ruled that firm could not accept postdated checks as prepetition retainer for postpetition services in Chapter 7 cases. UST moved to determine whether firm's new practice, under which separate contracts for prepetition and postpetition services were executed, violated prior ruling.

[Holding:] The Bankruptcy Court, Michael G. Williamson, J., held that new procedure did not violate prior ruling or conflict with Bankruptcy Code or professional conduct rule, warranting its approval, with proposed modifications.

Modified new procedure approved.

West Headnotes (2)

[1] **Bankruptcy** Post-petition transactions
Bankruptcy Attorneys

There is no prohibition against a debtor making postpetition installment payments for postpetition legal services.

3 Cases that cite this headnote

[2] **Attorney and Client** Making, requisites, and validity
Bankruptcy Effect of contract; prior compensation

New two-contract fee procedure employed by law firm in representing Chapter 7 and Chapter 13 debtors in consumer cases did not violate bankruptcy court's prior order barring previous arrangement under which firm had accepted postdated checks as prepetition retainer for postpetition services, and did not conflict with Bankruptcy Code or professional conduct rule, warranting court's approval of procedure, pursuant to which clients executed separate fee agreements for prepetition and postpetition services, prepetition agreement described procedure in detail and identified three options for postpetition legal services, clients received two-week cooling off period in which to select desired option, during which firm continued to provide representation, and firm continued to provide representation, if it was not selected as postpetition counsel, until allowed to withdraw by court order.

Cases that cite this headnote

Attorneys and Law Firms

***383** Denise E. Barnett, Tampa, FL, for Plaintiff.

Glenn E. Gallagher, Clark & Washington, LLC, Tampa, FL, Richard Thomson, Clark & Washington, P.C., Atlanta, GA, for Defendant.

AMENDED ORDER AND MEMORANDUM OPINION DETERMINING THAT CLARK & WASHINGTON'S TWO–CONTRACT PROCEDURE DOES NOT CONFLICT WITH THE COURT'S JULY 12, 2011 MEMORANDUM OPINION[1]

MICHAEL G. WILLIAMSON, Bankruptcy Judge.

This Court previously ruled in this miscellaneous proceeding that Clark & Washington ***384** was prohibited from accepting postdated checks as a prepetition retainer for postpetition services to be provided to their consumer clients.[2] Clark & Washington now has its clients execute two separate agreements: one for prepetition services and another for postpetition services. The agreement for prepetition services is executed before the petition is filed, and all services provided for under the agreement are completed with the filing of the chapter 7 petition. The relatively small payment for the prepetition services is also made before the petition is filed. The agreement for postpetition services is executed after the petition is filed. Payments under the postpetition retainer agreement are automatically debited from the debtor's bank account. The U.S. Trustee has moved to determine whether this new practice violates the Court's previous ruling.[3] For the reasons discussed below, the Court determines that, with certain modifications, this new practice is acceptable and does not conflict with the Court's previous ruling.

Background

The Defendant, Clark & Washington, P.C., is a law firm based in Atlanta, Georgia, with offices in various cities in the southeastern United States. Clark & Washington limits its practice to representing individual debtors in consumer cases filed

under Chapters 7 and 13 of the Bankruptcy Code. The U.S. Trustee originally filed this miscellaneous proceeding seeking a declaration that the prepetition fee agreement Clark & Washington used at the time, which depended upon the use of postdated checks for payment, was impermissible. This Court agreed with the U.S. Trustee's position and entered an order prohibiting Clark & Washington from using postdated checks as part of its fee agreement with clients. The U.S. Trustee now seeks a determination as to whether a new two-contract procedure used by the firm is permissible. To understand whether the new two-contract procedure is permissible, it is helpful to understand how Clark & Washington's original prepetition fee agreement worked and the reason that fee agreement was impermissible.

The Postdated Check Fee Agreement

Before this miscellaneous proceeding was filed in 2009, Clark & Washington regularly entered into fee agreements with its consumer clients under which it would receive a relatively small payment for its prepetition work and postdated checks as a "retainer" for its postpetition work. Typically, the client provided Clark & Washington with four or five postdated checks in equal amounts to pay this retainer. Clark & Washington deposited the checks on the date specified on the checks. ***385** The dates specified were always after the petition date, and in some instances, they were after the discharge had been entered.

The U.S. Trustee files this miscellaneous proceeding

The U.S. Trustee objected to that fee arrangement. So he filed this miscellaneous proceeding seeking a declaration that Clark & Washington's fee arrangement: (i) violated Bankruptcy Code § 362's automatic stay (Count I); (ii) violated Bankruptcy Code § 524's discharge injunction (Count II); and (iii) created a conflict of interest between Clark & Washington and its clients (Count III).[4] Clark & Washington moved for entry of summary judgment in its favor on all three counts of the U.S. Trustee's Complaint.[5]

The Court invalidates the Postdated Check Fee Agreement

In its July 12, 2011 Memorandum Opinion, the Court ruled that the postdated checks gave rise to prepetition claims as a matter of law and that depositing the checks after the petition date violated the § 362 automatic stay or the § 524 discharge injunction (depending on when the check was deposited). This Court also ruled that the fee arrangement created a conflict of interest. Accordingly, the Court prohibited Clark & Washington from accepting postdated checks for deposit after the petition date as payment of its fees for chapter 7 cases.

Clark & Washington implements a new two-contract procedure

After the Court's Memorandum Opinion, Clark & Washington modified its fee agreement to remove the provisions that the Court had found to be impermissible. The result was a new two-contract procedure under which the client executes separate fee agreements for prepetition and postpetition services. Under this new procedure, the client first agrees to retain Clark & Washington to prepare and file the chapter 7 petition. After the prepetition retainer agreement is signed, the initial intake is done and the petition and schedules are prepared. The client then comes back for a second appointment to sign the petition and schedules. Clark & Washington files the petition and then immediately prepares a postpetition retainer agreement, which the client executes while at the firm's office. The client also makes arrangements to pay the postpetition fees (generally in the form of automatic debits from the client's bank account) while at the firm's office. Once that is done, the balance of the schedules, statement of financial affairs, and other papers are filed. The fee for the prepetition services is generally $250, while the fee for the postpetition services is generally $1,000.

The U.S. Trustee filed the Motion to determine whether Clark & Washington's new two-contract procedure violates this Court's prior ruling.[6] At the initial hearing on the Motion, the Court expressed two key concerns about the firm's new procedure. First, the transition from the prepetition contract to the postpetition contract appeared to be one continuous process with no time for the client to consciously choose whether to retain the firm for postpetition services. Second, the disclosures in the initial contract did not appear to be sufficient to fully explain the client's options for postpetition services.

Clark & Washington modifies the two-contract procedure

As a result of the Court's comments at the initial hearing, Clark & Washington ***386** modified its two-contract procedure.[7] Under the modified procedure, the prepetition fee agreement describes the two-contract procedure in detail and sets forth the client's three options for postpetition legal services.[8] Those three options are: (i) the client can proceed pro se, (ii) the client can retain Clark & Washington, or (iii) the client can retain another firm.[9] Clark & Washington now gives its clients two weeks to exercise one of those three options; the debtor is no longer required to exercise one of those options on the same day the petition is filed.[10] In effect, Clark & Washington now provides a cooling off period. It is the validity of this modified two-contract procedure that is before the Court. The Court will next consider whether this modified procedure violates the Court's prior ruling or is otherwise legally impermissible.

Conclusions of Law[11]

As the Seventh Circuit recognized in *In re Bethea,* debtors "who cannot pay in full can tender a smaller retainer for prepetition work and later hire and pay counsel once the proceeding begins—for a lawyer's aid is helpful in prosecuting the case as well as in filing it."[12] The Supreme Court has also recognized that a debtor is free to use postpetition funds to pay for postpetition legal services.[13] Put another way, there is nothing inherently wrong with a lawyer giving terms to clients for the payment of legal services. As a consequence, the Court must uphold the validity of the modified two-contract procedure absent some compelling reason not to do so.

The Court, as set forth above, previously expressed two key concerns with the original two-contract procedure. Both of those concerns, however, have been substantially addressed by the modifications Clark & Washington made to its two-contract procedure. To begin with, under the modified two-contract procedure, the prepetition agreement now (i) more fully sets out the costs and fees associated with filing the client's case; and (ii) specifies the client's three options for postpetition legal services. Moreover, Clark & Washington's initial Rule 2016 disclosure statement explicitly specifies that the prepetition fee is $250 and that the contract between the client and the firm does not include postpetition services. Finally, the two-contract

procedure contemplates the firm filing a supplemental disclosure that sets out the additional $1,000 fee in the event the client retains Clark & Washington for postpetition services.

That leaves the three concerns raised by the U.S. Trustee.[14] First, the U.S. Trustee contends that, under the modified two-contract procedure, debtors are forced to proceed pro se from the time their petitions are filed until they decide whether to retain Clark & Washington or another firm (or continue proceeding pro se). According to the U.S. Trustee, this could cause problems because the client has to provide information to the chapter 7 trustee and prepare for the meeting of creditors ***387** during this "gap" period, and the client will be left without representation. Making matters worse, creditors, other lawyers, and the chapter 7 trustee will not know the client is proceeding pro se during the gap period. Second, the U.S. Trustee contends that the disclosures contained in Clark & Washington's prepetition and postpetition contracts are insufficient. Third, the U.S. Trustee says the two-contract procedure is simply unnecessary as there are other alternatives.

The first two concerns are valid. But neither of them warrants precluding Clark & Washington from implementing its modified two-contract procedure. To begin with, Clark & Washington has already addressed the U.S. Trustee's concern that clients will be left unrepresented. Under the modified two-contract procedure, the firm agrees to continue representing the client during the two-week "cooling off" period. And if the client opts to retain another firm or continue pro se, Clark & Washington will continue to represent the client until the Court enters an order allowing the firm to withdraw. In order to leave no doubt, the Court will require Clark & Washington to include in its initial Rule 2016 statement that the firm will represent the client until the Court enters an order allowing the firm to withdraw from representation. So that adequately resolves the U.S. Trustee's first concern.

The second concern—inadequate disclosure—is admittedly more problematic. In fact, Clark & Washington concedes the disclosures in its modified two-contract procedure could be improved. For starters, it has agreed—and the Court will require—that the firm move the "Two—Contract Procedure" disclosure from the end of each contract to a separate cover page. In addition, the firm has agreed to have their clients sign and acknowledge that they have received and read the two-contract procedure disclosures. These modifications resolve the U.S. Trustee's second concern.

As for the U.S. Trustee's third concern, the Court is not persuaded that the two-contract procedure is objectionable simply because there may be other alternatives. In this regard, the U.S. Trustee contends that there are other approaches that would allow individuals with modest means to obtain legal representation. Yet the U.S. Trustee does not identify any of those other approaches. And in any event, that is not the standard. Clark & Washington is not precluded from using one fee arrangement simply because other arrangements may exist.

Conclusion

[1] [2] In the end, there is no prohibition against a debtor making postpetition installment payments for postpetition services. The Court concludes that Clark & Washington's two-contract procedure—with the modifications directed by the Court and agreed to by the firm—does not violate the Court's July 12, 2011 Memorandum Opinion. Nor does it conflict with any applicable Bankruptcy Code provision or rule of professional conduct. Accordingly, it is

ORDERED:

1. Clark & Washington's new two-contract procedure set forth in the exhibits attached to its November 28, 2011 Response to the Court[15] is approved with the following modifications:

a. The "two-contract procedure" disclosure currently on pages 4–5 of the prepetition agreement and page 5 of the

postpetition agreement must be set forth on a separate cover page.

***388** b. Firm clients must acknowledge that they have received and read the "two-contract procedure" disclosure.

c. The client must execute the prepetition agreement before the bankruptcy case is filed and the postpetition agreement after the bankruptcy case is filed.

d. The postpetition agreement shall contain a provision notifying the client that (i) the client has the right to cancel the postpetition agreement—and all financial obligations arising under that agreement—at any time within 14 days after signing it; and (ii) the client may exercise his or her right to cancel the postpetition agreement by notifying Clark & Washington in writing (at the address designated by the firm) within 14 days after signing the agreement of his or her intent to cancel the agreement.

e. Clark & Washington shall include language in its initial Rule 2016 disclosure stating that the firm will continue to represent the debtor in the case even where the debtor chooses not to retain the firm for postpetition services until the Court enters an order allowing the firm to withdraw from representation.

2. The Court reserves jurisdiction to enforce the terms of this Order.

DONE and **ORDERED.**

All Citations

469 B.R. 383, 23 Fla. L. Weekly Fed. B 307, 23 Fla. L. Weekly Fed. B 339

Footnotes

1 This Amended Order and Memorandum Opinion supersedes the Court's April 20, 2012 Order and Memorandum Opinion Determining that Clark & Washington's Two–Contract Procedure Does Not Conflict with the Court's July 22, 2011 Memorandum Opinion (Doc. No. 66). Clark & Washington moved for reconsideration of decretal paragraph 1(d) of the Court's April 20, 2012 Order and Memorandum Opinion (Doc. No. 68). In light of that motion for reconsideration, the Court has amended decretal paragraph 1(d) to clarify the right of Clark & Washington's clients to cancel their postpetition contract. This Amended Order and Memorandum Opinion is otherwise identical in all respects to the April 20, 2012 Order and Memorandum Opinion.

2 *Walton v. Clark & Washington, P.C.*, 454 B.R. 537 (Bankr.M.D.Fla.2011).

3 Doc. No. 49 (the "Motion").

4 Doc. No. 1.

5 Doc. Nos. 32 & 33.

6 Doc. No. 49.

7 Doc. No. 56.

8 *Id.*

9 *Id.*

10 *Id.*

11 The Court has jurisdiction over this miscellaneous proceeding under section 28 U.S.C. § 1334(b) and 11 U.S.C. §§ 544,

550. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (H), and (O).

[12] *Bethea v. Robert J. Adams & Assocs.,* 352 F.3d 1125, 1128 (7th Cir.2003).

[13] *Lamie v. Trustee,* 540 U.S. 526, 535–36, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004).

[14] Doc. No. 57.

[15] Doc. No. 56.

Consumer Corner

By Daniel E. Garrison

Liberating Debtors from "Sweatbox" and Getting Attorneys Paid

Bifurcating Consumer Chapter 7 Engagements

Daniel E. Garrison
Fresh Start Funding, LLC; Phoenix

Daniel Garrison is a co-founder and managing director of Fresh Start Funding, LLC. Over the last 25 years, he established a national reputation in corporate restructuring.

Consumer debtors should have affordable and immediate access to bankruptcy without compromising their attorney's ability to be paid. However, unlike chapter 13, a chapter 7 attorneys' fees are not an administrative expense, and attorneys fear that unpaid, pre-petition fees are subject to the automatic stay and discharge. Accordingly, attorneys traditionally enter into pre-petition, "earned-on-receipt" engagements with chapter 7 debtors, and are paid in full before commencing the case.

Unfortunately, this traditional fee structure increasingly threatens the fundamental premise of bankruptcy. In 1877, the U.S. Supreme Court observed that consumer bankruptcy's purpose is to give a fresh start to the "honest but unfortunate debtor."[1] However, a fresh start is now becoming less attainable for many debtors because the traditional approach limits access to counsel and delays filing.

Increasingly, attorneys solve this problem by offering low- or $0-down terms to chapter 7 clients and bifurcating the engagement (splitting pre-petition and post-petition services into separate agreements to allow post-petition payments for post-petition work).[2] Despite its increasing prevalence, some remain skeptical on whether bifurcation is allowed under existing law. In fact, courts that have examined bifurcation either have approved it or noted its permissibility when done correctly.[3]

The Problem

Unsurprisingly, debtors in financial distress struggle to pay attorneys before obtaining the benefit of the automatic stay, particularly as chapter 7 attorneys' fees have climbed precipitously in recent years.[4] Consequently, debtors wait longer to file despite crushing financial pressure; more debtors file their cases *pro se*, creating burdens on the system; and some attorneys push clients toward "fee-only" chapter 13 cases as a way to provide debtors with immediate relief and post-petition payment terms.

Forcing debtors to languish in financial distress threatens their fresh start. In a forthcoming law review article by the co-investigators of the Consumer Bankruptcy Project (CPB),[5] they compare recent consumer/debtor data to earlier periods, concluding that consumers are spending longer than ever in the financial "sweatbox" before filing.[6] In so doing, debtors are "depleting assets [that are] key to building their post-bankruptcy lives," rendering the chance of their achieving a fresh start "even more tenuous."[7] "Long strugglers" (who languish for two or more years) end up losing their homes and selling other property, and have reported going without food and other necessities.[8] They also commonly arrive in bankruptcy with lower exempt assets and higher debts,[9] suggesting that the "sweatbox" adversely also affects creditors.

If debtors eventually file *pro se*, they have a far lower chance of achieving a fresh start than their represented counterparts. In their article, the CPB investigators noted that virtually all represented debtors obtain discharges, while more than 29 percent of *pro se* debtors fail to achieve a "fresh start."[10] *Pro se* debtors also disproportionately burden the system, requiring judges, trustees and staff to devote extra time and resources.[11] All of this is for naught, though, if a *pro se* debtor fails to receive a discharge.

Affordable representation and quicker relief clearly serve the system's purpose. However, one ill-conceived solution to this problem is the use of so-called "fee-only" chapter 13 plans. In order to offer post-petition payment terms, some attorneys convince debtors to file chapter 13 cases, knowing that the debtor's plan will only satisfy fees.[12]

1 *See, e.g.*, Margaret Howard, "A Theory of Discharge in Consumer Bankruptcy," 48 *Ohio St. L. J.* 1047 and n.1 (1986).
2 Hon. Robert E. Ginsberg and Hon. Robert D. Martin, *Ginsberg & Martin on Bankruptcy*, § 4.05[E] (Aspen Publishers 2008).
3 *See infra.*
4 Lois R. Lupica, "The Consumer Bankruptcy Fee Study: Final Report," 20 *ABI Law Review* 17, 30 (Spring 2012), *available at* abi.org/member-resources/law-review (unless otherwise specified, all links in this article were last visited on April 30, 2018).
5 Pamela Foohey, Robert M. Lawless, Katherine M. Porter and Deborah Thorne, "Life in the Sweatbox," *Notre Dame L. Rev.* (forthcoming 2018), *available at* www.creditslips.org/creditslips/2018/02/peoples-pre-bankruptcy-struggles-new-paper-from-consumer-bankruptcy-project.html.
6 *Id.* at 1.
7 *Id.* at 4-5.
8 *Id.* at 2.
9 *Id.* at 23-24.
10 *Id.* at 8, n.34, and 10, n.53.
11 *See* Lois R. Lupica and Nancy B. Rapoport, "Best Practices for Limited Services Representation in Consumer Bankruptcy Cases," *ABI National Ethics Task Force Final Report* (April 21, 2013), *available at* abi-org-corp.s3.amazonaws.com/materials/Final_Report_ABI_Ethics_Task_Force.pdf.
12 *See* Katherine M. Porter, Pamela Foohey, Robert M. Lawless and Deborah Thorne, "No Money Down Bankruptcy," 90 *S. Cal. L. Rev.* 1055, 1058.

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Consumer Corner: Liberating Debtors from the "Sweatbox"

from page 16

Chapter 13 fees are higher than chapter 7 fees,[13] and chapter 13 cases are more burdensome on the system, and discharge rates are alarmingly lower than under chapter 7.[14] Unfortunately, the availability of post-petition payment terms remains a powerful inducement for debtors to choose chapter 13 where payment terms are not available for chapter 7.[15]

No one should hold their breath waiting for Congress to amend the Bankruptcy Code. It has been two decades since the Ninth Circuit commented on the problem in *Gordon v. Hines*,[16] and Congress has not acted:

> [B]ecause Congress has failed to correct that oversight in express terms, we are compelled to consider an appropriate judicial response — one that recognizes that the very administration of the bankruptcy system requires that attorneys for Chapter 7 debtors must have a legally enforceable right for their post-petition services that were contracted for before filing of the petition. *If the absence of such a right were to become the law, it does not require much thought to recognize that the entire system would suffer a massive breakdown*.[17]

While the *Hines* court adopted a *quantum meruit* solution to allow the post-petition collection of fees,[18] bifurcation offers a more direct and sensible solution that is consistent with the Code and existing case law — and therefore does not require Congress to act.

The Solution: Bifurcation

The viability of bifurcation is obvious when placed into the context of well-accepted practices. No one questions that a debtor can pay for post-petition legal services with post-petition earnings.[19] Consequently, a consumer could use a document preparer or draft their own petition, and later hire and pay an attorney. Likewise, a debtor could hire one attorney to file the case, then replace that attorney with another after filing. In each situation, an attorney is retained and paid post-petition for providing all required chapter 7 services beyond filing a "naked" petition. Bifurcation should not be treated differently.

One might well ask why it is preferable to allow a debtor to use pre-petition assets to *pre-pay* for services that indisputably will be rendered post-petition. Attorneys arguably do not have an enforceable right to payment until services are rendered,[20] leading at least one court to order disgorgement of a sizeable, "earned-on-receipt" retainer to defend an anticipated nondischargeability claim.[21]

A debtor's circumstances sometimes require that a petition be filed quickly, leaving a good portion of the work in the case to be done post-petition. Some bifurcation critics have suggested that filing a "naked" petition is only permissible in exigent circumstances, but this is belied by the black-letter text of Rule 1007. Only a limited number of items must be filed with the petition, and the "schedules, statements and other documents required by subdivisions (b)(1), (4), (5), and (6)" could "be filed with the petition *or* within 14 days thereafter," except as otherwise provided in the rule.[22] Likewise, the financial-management course certification might be filed within 60 days after the first meeting of creditors (which also occurs post-petition).[23] Finally, all of these post-petition deadlines can be extended at the court's discretion.[24] Any argument that this work must be completed prior to the petition date is unsupportable — and when debtors are in the "sweatbox," it is patently against their interest to artificially increase the waiting time for relief.

> **Preventing debtors from taking advantage of a bifurcated engagement and post-petition payment terms where adequate disclosures have been made serves no valid purpose and instead hurts the entire bankruptcy system.**

Thus, the narrow question is whether the *same attorney* can represent the debtor both before and after the filing of the petition under separate agreements, and be paid for post-petition work from post-petition earnings or other non-estate assets. The answer is an unequivocal "yes."

Despite the Bankruptcy Code lacking an explicit reference, courts have issued well-reasoned, thoughtful decisions approving bifurcation or noting its viability if done correctly. These decisions distill the requirements to certain key elements.

First, there must be legitimate pre-petition and post-petition engagement agreements. Second, the post-petition fee must be reasonable for the post-petition work, which must be competently performed. Finally, the attorney must obtain the debtor's informed consent after appropriate disclosures, including the options to a bifurcated engagement.

In one such case, *Walton v. Clark & Washington PC*,[25] a bankruptcy court approved a bifurcated engagement that involved a separate, post-petition agreement with post-petition payment terms. At the court's urging, the firm adopted disclosures describing the client's options for post-petition

13 Noting an average chapter 7 fee of $1,229, as opposed to an average chapter 13 fee of $3,217. *Id.* at 1058 and n.10.
14 *See id.* at 1060.
15 *See id.* ("[C]hapter choice is powerfully shaped by when debtors must pay their attorneys and how attorneys can receive payments.").
16 *Gordon v. Hines (In re Hines)*, 147 F.3d 1185 (9th Cir. 1998).
17 *Id.* at 1190-91 (emphasis added).
18 *See id.* at 1191-92.
19 *See, e.g., Walton v. Clark & Washington PC (In re Walton)*, 469 B.R. 383, 386 and n.13 (Bankr. M.D. Fla. 2012) (citing *Lamie v. Trustee*, 540 U.S. 526, 535-36 (2004)).
20 *See, e.g., In re Mansfield*, 349 B.R. 783, 791-92 (Bankr. E.D. Pa. 2008).
21 *See In re Boates*, 551 B.R. 428 (B.A.P. 9th Cir. 2016).
22 Fed. R. Bankr. P. 1007(c).
23 *Id.*
24 *Id.*
25 454 B.R. 383 (M.D. Fla. 2012).

legal services: "(i) the client can proceed *pro se*, (ii) the client can retain [the firm], or (iii) the client can retain another firm."[26] Determining that this two-contract process is consistent with the Code, the *Walton* court quoted the Seventh Circuit Court of Appeals that "debtors 'who cannot pay in full can tender a smaller retainer for pre-petition work and later hire and pay counsel once the proceeding begins — for a lawyer's aid is helpful in prosecuting the case as well as in filing it.'"[27]

The court also rejected the U.S. Trustee's argument that the bifurcated agreement left the debtor without counsel during a "cooling-off" period between the filing and date of the post-petition agreement, noting that "[u]nder the modified two-contract procedure, the firm agrees to continue representing the client ... until the Court enters an order allowing the firm to withdraw."[28] The *Walton* court concluded, "In the end, there is no prohibition against a debtor making post-petition installment payments for post-petition services."[29]

Another bankruptcy court approved a very similar structure.[30] In *Slabbinck*, the debtor also executed two separate agreements, and the court rejected an argument by the U.S. Trustee that "the Pre-Petition Agreement and the Post-Petition Agreement are essentially a single, pre-petition agreement giving rise to an entirely pre-petition debt."[31] The court similarly rejected an argument that the firm could not legally "unbundle the legal services that it would perform for the Debtors into pre-petition and post-petition services," noting that this argument had no basis in the Code or controlling law.[32]

In other cases, courts have disallowed particular fee structures, but also described how a properly structured bifurcation is permissible. In *Mansfield*, a Pennsylvania attorney utilized a traditional, pre-petition "flat-fee" engagement structure, but tried to collect fees after the case had been filed.[33] Although ultimately prohibiting the attorney's post-petition collection, finding that a "flat-fee" contract could not be judicially bifurcated,[34] the court noted that if there is a separate, post-petition agreement, bifurcation is allowed.[35] Another bankruptcy court had similarly opined that a separate post-petition contract for post-petition services was enforceable, despite disallowing a nonconforming arrangement in the case under review.[36]

The post-petition fee must be reasonable, but in a bifurcated case (and especially where post-petition installment terms are offered), "reasonability" must take into consideration very different circumstances than a traditional case. Bifurcation takes additional work, as the documentation is more intensive and an attorney must take on at least one additional client meeting.

Disclosures are also more numerous and complicated. Where payment terms are offered, an agreement must be negotiated for the amount, timing and duration of those payments. Moreover, there is additional work and risk in accepting installments over many months. Where attorneys obtain financing to assist with cash flow and payment administration, there may be direct financing costs.

However, a higher fee might be more attractive than any other alternatives available to the debtor. For example, the alternative to post-petition payment terms might be to live with a continuing garnishment. A minimum-wage earner working 30 hours per week meets the minimum threshold to be garnished at the federal maximum of 25 percent of gross wages, resulting in monthly garnishment of more than $235. If a $2,000 fee is paid in 12 monthly installments, the monthly payment is significantly lower (about $167 per month), and those payments will end in 12 months, whereas a garnishment might not. So long as all of this is made plain to the debtor, the law supports them choosing what is best for them.

One last objection to bifurcation seems to be the concern with "unbundling" typical chapter 7 services. This well-intentioned concern that attorneys might mislead unsophisticated and vulnerable debtors into limited engagements that are not in their best interest is misplaced in the bifurcation scenario. In bifurcation, the attorney's intention is not to *limit* the scope of the engagement, but rather to *split* it into its pre- and post-petition components and offer post-petition payment terms. Just as a debtor could choose to use a document preparer or prepare his/her own petition, then hire counsel, they should be allowed to choose to hire the same attorney in a bifurcated engagement.

Obviously, this choice requires informed consent after robust disclosure. At a minimum, attorneys should disclose (1) the scope of the pre-petition services, (2) the existence of options to the post-petition engagement, (3) the risks of proceeding *pro se*, (4) whether the post-petition installment option involves a higher fee than if the debtor paid in cash, and (5) that the attorney will remain counsel of record in the case until and unless the court allows withdrawal.

Conclusion

Preventing debtors from taking advantage of a bifurcated engagement and post-petition payment terms where adequate disclosures have been made serves no valid purpose and instead hurts the entire bankruptcy system. In fact, there is no case law disallowing the practice, and well-reasoned decisions have supported it.

Bifurcation and access to post-petition payment terms provides an escape from the "sweatbox," allows attorneys to be paid post-petition and to access working-capital financing solutions, and mitigates the systemic burdens created by *pro se* debtors. Such a "win-win" scenario is too rare an occurrence to ignore. abi

26 *Id.* at 385-86.
27 *Id.* at 386 (quoting *Bethea v. Robert J. Adams & Assoc.*, 352 F.3d 1125, 1128 (7th Cir. 2003)).
28 *Id.* at 387.
29 *Id.*
30 *See In re Slabbinck*, 482 B.R. 576 (Bankr. E.D. Mich. 2012).
31 *Id.* at 583.
32 *Id.*
33 *See In re Mansfield*, 394 B.R. 783 (Bankr. E.D. Pa. 2008).
34 *See id.* at 791.
35 *Id.* at 792-93.
36 *See In re Griffin*, 313 B.R. 757, 769-70 (Bankr. N.D. Ill. 2004).

6. JUDGE MARTIN BARASH

Topic: 546(e) Safe Harbor — *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 200 L. Ed. 2d 183 (2018)

138 S.Ct. 883
Supreme Court of the United States

MERIT MANAGEMENT GROUP, LP, Petitioner
v.
FTI CONSULTING, INC.

No. 16–784.
|
Argued Nov. 6, 2017.
|
Decided Feb. 27, 2018.

Synopsis

Background: Trustee of litigation trust created pursuant to confirmed Chapter 11 plan of debtor, an entity that sought to develop a "racino" in Pennsylvania, brought adversary proceeding, seeking to avoid debtor's allegedly fraudulent transfers of $16,503,850 to transferee, the partial owner of debtor's competitor, as part of debtor's purchase of competitor's stock. The United States District Court for the Northern District of Illinois, Joan B. Gottschall, J., 541 B.R. 850, granted motion for judgment on the pleadings in transferee's favor. Trustee appealed. The Seventh Circuit Court of Appeals, Wood, Chief Judge, 830 F.3d 690, reversed. Certiorari was granted.

Holdings: The Supreme Court, Justice Sotomayor, held that:

[1] the only relevant transfer for purposes of the Bankruptcy Code's "securities safe harbor" provision is the transfer that the trustee seeks to avoid under a substantive avoiding power, abrogating *In re Quebecor World (USA) Inc.*, 719 F.3d 94, *In re QSI Holdings, Inc.*, 571 F.3d 545, *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, *In re Resorts Int'l, Inc.*, 181 F.3d 505, and *In re Kaiser Steel Corp.*, 952 F.2d 1230, and

[2] in the present case, the transfer between debtor and transferee was not "made by or to (or for the benefit of)" a financial institution and so fell outside the safe harbor.

Affirmed and remanded.

West Headnotes (11)

[1] **Bankruptcy** Trustee as representative of debtor or creditors

Bankruptcy Code gives a trustee "avoiding powers," that is, the power to invalidate a limited category of transfers by the debtor or transfers of an interest of the debtor in property, in order to maximize the funds available for, and ensure equity in, the distribution to creditors in a bankruptcy proceeding.

1 Cases that cite this headnote

[2] **Bankruptcy** Avoidance rights and limits thereon, in general

Avoiding powers set forth in the Bankruptcy Code may be exercised by debtors, trustees, or creditors committees, depending on the circumstances of the case.

Cases that cite this headnote

[3] **Bankruptcy** Trustee as representative of debtor or creditors

Trustee's avoiding powers help implement the core principles of bankruptcy; some deter the race of diligence of creditors to dismember the debtor before bankruptcy and promote equality of distribution, while others set aside transfers that unfairly or improperly deplete assets or dilute the claims against those assets.

Cases that cite this headnote

[4] **Public Amusement and Entertainment** Horse and dog racing

Harness racing is a closely regulated industry in Pennsylvania, and the Commonwealth requires a license to operate a racetrack.

Cases that cite this headnote

[5] **Bankruptcy** Avoidance rights and limits thereon, in general

The only relevant transfer for purposes of the Bankruptcy Code's "securities safe harbor" provision is the transfer that the trustee seeks to avoid under one of the Code's substantive avoidance provisions, that is, the overarching or end-to-end transfer, not any component part of that transfer; abrogating *In re Quebecor World (USA) Inc.*, 719 F.3d 94, *In re QSI Holdings, Inc.*, 571 F.3d 545, *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, *In re Resorts Int'l, Inc.*, 181 F.3d 505, and *In re Kaiser Steel Corp.*, 952 F.2d 1230. 11 U.S.C.A. § 546(e).

Cases that cite this headnote

[6] **Statutes** Language
Statutes Context

In construing a statute, courts look to both the language itself and the specific context in which that language is used.

1 Cases that cite this headnote

[7] **Bankruptcy** Avoidance rights and limits thereon, in general

Bankruptcy Code's "securities safe harbor" provision operates as an exception to the avoiding powers afforded to the trustee under the Code's substantive avoidance provisions; that is, when faced with a transfer that is otherwise avoidable, it provides a safe harbor notwithstanding that avoiding power. 11 U.S.C.A. § 546(e).

1 Cases that cite this headnote

[8] **Statutes** Titles, headings, and captions

Although section headings cannot limit the plain meaning of a statutory text, they supply cues as to what Congress intended.

Cases that cite this headnote

[9] **Bankruptcy** Trustee as representative of debtor or creditors

Bankruptcy trustee, in exercising its avoidance powers, is not free to define the transfer that it seeks to avoid in any way it chooses; instead, that transfer is necessarily defined by the carefully set out criteria in the Bankruptcy Code. 11 U.S.C.A. §§ 544(a), 545, 547(b), 548(a)(1).

Cases that cite this headnote

[10] **Bankruptcy** Avoidance rights and limits thereon, in general

Under the Bankruptcy Code's "securities safe harbor," if the transfer that the trustee seeks to avoid was made "by" or "to" a securities clearing agency, then the safe harbor will bar avoidance, and it will do so without regard to whether the entity acted only as an intermediary; the safe harbor will, in addition, bar avoidance if the transfer was made "for the benefit of" that securities clearing agency, even if it was not made "by" or "to" that entity. 11

U.S.C.A. § 546(e).

2 Cases that cite this headnote

[11] **Bankruptcy** Avoidance rights and limits thereon, in general

Prepetition transfer by Chapter 11 debtor to transferee, the partial owner of debtor's competitor, as part of debtor's purchase of competitor's stock, fell outside the Bankruptcy Code's "securities safe harbor"; trustee sought to avoid, as constructively fraudulent, the overarching transfer between debtor and transferee, not any of the component transactions involving a bank and a lender by which that overarching transfer was executed, and it was undisputed that neither debtor nor transferee was a financial institution or any other covered entity. 11 U.S.C.A. §§ 546(e), 548(a)(1)(B).

Cases that cite this headnote

***885** *Syllabus*[*]

The Bankruptcy Code allows trustees to set aside and recover certain transfers for the benefit of the bankruptcy estate, including, as relevant here, certain fraudulent transfers "of an interest of the debtor in property." 11 U.S.C. § 548(a). It also sets out a number of limits on the exercise of these avoiding powers. Central here is the securities safe harbor, which, *inter alia,* provides that "the trustee may not avoid a transfer that is a ... settlement payment ... made by or to (or for the benefit of) a ... financial institution ... or that is a transfer made by or to (or for the benefit of) a ... financial institution ... in connection with a securities contract." § 546(e).

Valley View Downs, LP, and Bedford Downs Management Corp. entered into an agreement under which Valley View, if it got the last harness-racing license in Pennsylvania, would purchase all of Bedford Downs' stock for $55 million. Valley View was granted the license and arranged for the Cayman Islands branch of Credit Suisse to wire $55 million to third-party escrow agent Citizens Bank of Pennsylvania. The Bedford Downs shareholders, including petitioner Merit Management Group, LP, deposited their stock certificates into escrow. Citizens Bank disbursed the $55 million over two installments according to the agreement, of which petitioner Merit received $16.5 million.

Although Valley View secured the harness-racing license, it was unable to achieve its goal of opening a racetrack casino. Valley View and its parent company, Centaur, LLC, filed for Chapter 11 bankruptcy. Respondent FTI Consulting, Inc., was appointed to serve as trustee of the Centaur litigation trust. FTI then sought to avoid the transfer from Valley View to Merit for the sale of Bedford Downs' stock, arguing that it was constructively fraudulent under § 548(a)(1)(B). Merit contended that the § 546(e) safe harbor barred FTI from avoiding the transfer because it was a "settlement payment ... made by or to (or for the benefit of)" two "financial institutions," Credit Suisse and Citizens Bank. The District Court agreed with Merit, but the Seventh ***886** Circuit reversed, holding that § 546(e) did not protect transfers in which financial institutions served as mere conduits.

Held : The only relevant transfer for purposes of the § 546(e) safe harbor is the transfer that the trustee seeks to avoid. Pp. 891 – 897.

(a) Before a court can determine whether a transfer was "made by or to (or for the benefit of)" a covered entity, it must first

identify the relevant transfer to test in that inquiry. Merit posits that the relevant transfer should include not only the Valley–View–to–Merit end-to-end transfer, but also all of its component parts, *i.e.,* the Credit–Suisse–to–Citizens–Bank and the Citizens–Bank–to–Merit transfers. FTI maintains that the only relevant transfer is the transfer that it sought to avoid, specifically, the overarching transfer between Valley View and Merit. Pp. 891 – 895.

(1) The language of § 546(e) and the specific context in which that language is used support the conclusion that the relevant transfer for purposes of the safe-harbor inquiry is the transfer the trustee seeks to avoid. The first clause of the provision—"Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title"—indicates that § 546(e) operates as an exception to trustees' avoiding powers granted elsewhere in the Code. The text makes clear that the starting point for the § 546(e) inquiry is the expressly listed avoiding powers and, consequently, the transfer that the trustee seeks to avoid in exercising those powers. The last clause—"except under section 548(a)(1)(A) of this title"—also focuses on the transfer that the trustee seeks to avoid. Creating an exception to the exception for § 548(a)(1)(A) transfers, the text refers back to a specific type of transfer that falls within the avoiding powers, signaling that the exception applies to the overarching transfer that the trustee seeks to avoid, not any component part of that transfer. This reading is reinforced by the § 546 section heading, "Limitations on avoiding powers," and is confirmed by the rest of the statutory text: The provision provides that "the trustee may not avoid" certain transfers, which naturally invites scrutiny of the transfers that "the trustee ... may avoid," the parallel language used in the avoiding powers provisions. The text further provides that the transfer that is saved from avoidance is one "that *is* " (not one that involves) a securities transaction covered under § 546(e). In other words, to qualify for protection under the securities safe harbor, § 546(e) provides that the otherwise avoidable transfer itself be a transfer that meets the safe-harbor criteria. Pp. 893 – 894.

(2) The statutory structure also supports this reading of § 546(e). The Code establishes a system for avoiding transfers as well as a safe harbor from avoidance. It is thus only logical to view the pertinent transfer under § 546(e) as the same transfer that the trustee seeks to avoid pursuant to one of its avoiding powers. In an avoidance action, the trustee must establish that the transfer it seeks to set aside meets the carefully set out criteria under the substantive avoidance provisions of the Code. The defendant in that avoidance action is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer. If a trustee properly identifies an avoidable transfer, however, the court has no reason to examine the relevance of component parts when considering a limit to the avoiding power, where that limit is defined by reference to an otherwise avoidable transfer, as is the case with § 546(e). Pp. 894 – 895.

***887** (b) The primary argument Merit advances that is moored in the statutory text—concerning Congress' 2006 addition of the parenthetical "(or for the benefit of)" to § 546(e)—is unavailing. Merit contends that Congress meant to abrogate the Eleventh Circuit decision in *In re Munford, Inc.,* 98 F.3d 604, which held that § 546(e) was inapplicable to transfers in which a financial institution acted only as an intermediary. However, Merit points to nothing in the text or legislative history to corroborate its argument. A simpler explanation rooted in the text of the statute and consistent with the interpretation of § 546(e) adopted here is that Congress added the "or for the benefit of" language that is common in other substantive avoidance provisions to the § 546(e) safe harbor to ensure that the scope of the safe harbor and scope of the avoiding powers matched.

That reading would not, contrary to what Merit contends, render other provisions ineffectual or superfluous. Rather, it gives full effect to the text of § 546(e). If the transfer the trustee seeks to avoid was made "by" or "to" a covered entity, then § 546(e) will bar avoidance without regard to whether the entity acted only as an intermediary. It will also bar avoidance if the transfer was made "for the benefit of" that entity, even if it was not made "by" or "to" that entity.

Finally, Merit argues that reading the safe harbor so that its application depends on the identity of the investor and the manner in which its investment is held rather than on the general nature of the transaction is incongruous with Congress' purportedly "prophylactic" approach to § 546(e). But this argument is nothing more than an attack on the text of the statute, which protects only certain transactions "made by or to (or for the benefit of)" certain covered entities. Pp. 894 – 896.

(c) Applying this reading of the § 546(e) safe harbor to this case yields a straightforward result. FTI sought to avoid the Valley–View–to–Merit transfer. When determining whether the § 546(e) safe harbor saves that transfer from avoidance liability, the Court must look to that overarching transfer to evaluate whether it meets the safe-harbor criteria. Because the

parties do not contend that either Valley View or Merit is a covered entity, the transfer falls outside of the § 546(e) safe harbor. Pp. 896 – 897.

830 F.3d 690, affirmed and remanded.

SOTOMAYOR, J., delivered the opinion for a unanimous Court.

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Opinion

Justice SOTOMAYOR delivered the opinion of the Court.

[1] To maximize the funds available for, and ensure equity in, the distribution to creditors in a bankruptcy proceeding, the Bankruptcy Code gives a trustee the power to invalidate a limited category of ***888** transfers by the debtor or transfers of an interest of the debtor in property. Those powers, referred to as "avoiding powers," are not without limits, however, as the Code sets out a number of exceptions. The operation of one such exception, the securities safe harbor, 11 U.S.C. § 546(e), is at issue in this case. Specifically, this Court is asked to determine how the safe harbor operates in the context of a transfer that was executed via one or more transactions, *e.g.,* a transfer from A → D that was executed via B and C as intermediaries, such that the component parts of the transfer include A → B → C → D. If a trustee seeks to avoid the A → D transfer, and the § 546(e) safe harbor is invoked as a defense, the question becomes: When determining whether the § 546(e) securities safe harbor saves the transfer from avoidance, should courts look to the transfer that the trustee seeks to avoid (*i.e.,* A → D) to determine whether that transfer meets the safe-harbor criteria, or should courts look also to any component parts of the overarching transfer (*i.e.,* A → B → C → D)? The Court concludes that the plain meaning of § 546(e) dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid.

I

A

[2] [3] Because the § 546(e) safe harbor operates as a limit to the general avoiding powers of a bankruptcy trustee,[1] we begin with a review of those powers. Chapter 5 of the Bankruptcy Code affords bankruptcy trustees the authority to "se[t] aside

certain types of transfers ... and ... recaptur[e] the value of those avoided transfers for the benefit of the estate." Tabb § 6.2, p. 474. These avoiding powers "help implement the core principles of bankruptcy." *Id.,* § 6.1, at 468. For example, some "deter the race of diligence of creditors to dismember the debtor before bankruptcy" and promote "equality of distribution." *Union Bank v. Wolas,* 502 U.S. 151, 162, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991) (internal quotation marks omitted); see also Tabb § 6.2. Others set aside transfers that "unfairly or improperly deplete ... assets or ... dilute the claims against those assets." 5 Collier on Bankruptcy ¶ 548.01, p. 548–10 (16th ed. 2017); see also Tabb § 6.2, at 475 (noting that some avoiding powers are designed "to ensure that the debtor deals fairly with its creditors").

Sections 544 through 553 of the Code outline the circumstances under which a trustee may pursue avoidance. See, *e.g.,* 11 U.S.C. § 544(a) (setting out circumstances under which a trustee can avoid unrecorded liens and conveyances); § 544(b) (detailing power to avoid based on rights that unsecured creditors have under nonbankruptcy law); § 545 (setting out criteria that allow a trustee to avoid a statutory lien); § 547 (detailing criteria for avoidance of so-called "preferential transfers"). The particular avoidance provision at issue here is § 548(a), which provides that a "trustee may avoid" certain fraudulent transfers "of an interest of the debtor in property." § 548(a)(1). Section 548(a)(1)(A) addresses so-called "actually" fraudulent transfers, which are "made ... with actual intent to hinder, delay, or defraud ***889** any entity to which the debtor was or became ... indebted." Section 548(a)(1)(B) addresses "constructively" fraudulent transfers. See *BFP v. Resolution Trust Corporation,* 511 U.S. 531, 535, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994). As relevant to this case, the statute defines constructive fraud in part as when a debtor:

> "(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> "(ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation. 11 U.S.C. § 548(a)(1).

If a transfer is avoided, § 550 identifies the parties from whom the trustee may recover either the transferred property or the value of that property to return to the bankruptcy estate. Section 550(a) provides, in relevant part, that "to the extent that a transfer is avoided ... the trustee may recover ... the property transferred, or, if the court so orders, the value of such property" from "the initial transferee of such transfer or the entity for whose benefit such transfer was made," or from "any immediate or mediate transferee of such initial transferee." § 550(a).

B

The Code sets out a number of limits on the exercise of these avoiding powers. See, *e.g.,* § 546(a) (setting statute of limitations for avoidance actions); §§ 546(c)-(d) (setting certain policy-based exceptions to avoiding powers); § 548(a)(2) (setting limit to avoidance of "a charitable contribution to a qualified religious or charitable entity or organization"). Central to this case is the securities safe harbor set forth in § 546(e), which provides (as presently codified and in full):

> "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

The predecessor to this securities safe harbor, formerly codified at 11 U.S.C. § 764(c), was enacted in 1978 against the backdrop of a district court decision in a case called *Seligson v. New York Produce Exchange,* 394 F.Supp. 125 (S.D.N.Y.1975), which involved a transfer by a bankrupt commodity broker. See S. Rep. No. 95–989, pp. 8, 106 (1978); see also Brubaker, Understanding the Scope of the § 546(e) Securities Safe Harbor Through the Concept of the "Transfer" Sought To Be Avoided, 37 Bkrtcy. L. Letter 11–12 (July 2017). The bankruptcy trustee in *Seligson* filed suit seeking to avoid over $12 million in margin payments made by the commodity broker debtor to a clearing association on the basis that the transfer was constructively fraudulent. The clearing association attempted to defend on the theory that it was a mere "conduit" for the transmission of the margin payments. 394 F.Supp., at 135. The District Court found, however, triable issues of fact on that question and denied summary judgment, ***890** leaving the clearing association exposed to the risk of significant liability. See *id.,* at 135–136. Following that decision, Congress enacted the § 764(c) safe harbor, providing that "the trustee may not avoid a transfer that is a margin payment to or deposit with a commodity broker or forward contract merchant or is a settlement payment made by a clearing organization." 92 Stat. 2619, codified at 11 U.S.C. § 764(c) (repealed 1982).

Congress amended the securities safe harbor exception over the years, each time expanding the categories of covered transfers or entities. In 1982, Congress expanded the safe harbor to protect margin and settlement payments "made by or to a commodity broker, forward contract merchant, stockbroker, or securities clearing agency." § 4, 96 Stat. 236, codified at 11 U.S.C. § 546(d). Two years later Congress added "financial institution" to the list of protected entities. See § 461(d), 98 Stat. 377, codified at 11 U.S.C. § 546(e).[2] In 2005, Congress again expanded the list of protected entities to include a "financial participant" (defined as an entity conducting certain high-value transactions). See § 907(b), 119 Stat. 181–182; 11 U.S.C. § 101(22A). And, in 2006, Congress amended the provision to cover transfers made in connection with securities contracts, commodity contracts, and forward contracts. § 5(b)(1), 120 Stat. 2697–2698. The 2006 amendment also modified the statute to its current form by adding the new parenthetical phrase "(or for the benefit of)" after "by or to," so that the safe harbor now covers transfers made "by or to (or for the benefit of)" one of the covered entities. *Id.,* at 2697.

C

[4] With this background, we now turn to the facts of this case, which comes to this Court from the world of competitive harness racing (a form of horse racing). Harness racing is a closely regulated industry in Pennsylvania, and the Commonwealth requires a license to operate a racetrack. See *Bedford Downs Management Corp. v. State Harness Racing Comm'n,* 592 Pa. 475, 485–487, 926 A.2d 908, 914–915 (2007) (*per curiam*). The number of available licenses is limited, and in 2003 two companies, Valley View Downs, LP, and Bedford Downs Management Corporation, were in competition for the last harness-racing license in Pennsylvania.

Valley View and Bedford Downs needed the harness-racing license to open a " 'racino,' " which is a clever moniker for racetrack casino, "a racing facility with slot machines." Brief for Petitioner 8. Both companies were stopped before the finish ***891** line, because in 2005 the Pennsylvania State Harness Racing Commission denied both applications. The Pennsylvania Supreme Court upheld those denials in 2007, but allowed the companies to reapply for the license. See *Bedford Downs,* 592 Pa., at 478–479, 926 A.2d, at 910.

Instead of continuing to compete for the last available harness-racing license, Valley View and Bedford Downs entered into an agreement to resolve their ongoing feud. Under that agreement, Bedford Downs withdrew as a competitor for the harness-racing license, and Valley View was to purchase all of Bedford Downs' stock for $55 million after Valley View obtained the license.[3]

With Bedford Downs out of the race, the Pennsylvania Harness Racing Commission awarded Valley View the last harness-racing license. Valley View proceeded with the corporate acquisition required by the parties' agreement and arranged

for the Cayman Islands branch of Credit Suisse to finance the $55 million purchase price as part of a larger $850 million transaction. Credit Suisse wired the $55 million to Citizens Bank of Pennsylvania, which had agreed to serve as the third-party escrow agent for the transaction. The Bedford Downs shareholders, including petitioner Merit Management Group, LP, deposited their stock certificates into escrow as well. At closing, Valley View received the Bedford Downs stock certificates, and in October 2007 Citizens Bank disbursed $47.5 million to the Bedford Downs shareholders, with $7.5 million remaining in escrow at Citizens Bank under the multiyear indemnification holdback period provided for in the parties' agreement. Citizens Bank disbursed that $7.5 million installment to the Bedford Downs shareholders in October 2010, after the holdback period ended. All told, Merit received approximately $16.5 million from the sale of its Bedford Downs stock to Valley View. Notably, the closing statement for the transaction reflected Valley View as the "Buyer," the Bedford Downs shareholders as the "Sellers," and $55 million as the "Purchase Price." App. 30.

In the end, Valley View never got to open its racino. Although it had secured the last harness-racing license, it was unable to secure a separate gaming license for the operation of the slot machines in the time set out in its financing package. Valley View and its parent company, Centaur, LLC, thereafter filed for Chapter 11 bankruptcy. The Bankruptcy Court confirmed a reorganization plan and appointed respondent FTI Consulting, Inc., to serve as trustee of the Centaur litigation trust.

FTI filed suit against Merit in the Northern District of Illinois, seeking to avoid the $16.5 million transfer from Valley View to Merit for the sale of Bedford Downs' stock. The complaint alleged that the transfer was constructively fraudulent under § 548(a)(1)(B) of the Code because Valley View was insolvent when it purchased Bedford Downs and "significantly overpaid" for the Bedford Downs stock.[4] Merit moved for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), contending that the § 546(e) safe harbor barred FTI from avoiding the Valley View–to–Merit transfer. According to Merit, the safe harbor applied because the transfer was a "settlement payment ***892** ... made by or to (or for the benefit of)" a covered "financial institution"—here, Credit Suisse and Citizens Bank.

The District Court granted the Rule 12(c) motion, reasoning that the § 546(e) safe harbor applied because the financial institutions transferred or received funds in connection with a "settlement payment" or "securities contract." See 541 B.R. 850, 858 (N.D.Ill.2015).[5] The Court of Appeals for the Seventh Circuit reversed, holding that the § 546(e) safe harbor did not protect transfers in which financial institutions served as mere conduits. See 830 F.3d 690, 691 (2016). This Court granted certiorari to resolve a conflict among the circuit courts as to the proper application of the § 546(e) safe harbor.[6] 581 U.S. ——, 137 S.Ct. 2092, 197 L.Ed.2d 894 (2017).

II

[5] The question before this Court is whether the transfer between Valley View and Merit implicates the safe harbor exception because the transfer was "made by or to (or for the benefit of) a ... financial institution." § 546(e). The parties and the lower courts dedicate much of their attention to the definition of the words "by or to (or for the benefit of)" as used in § 546(e), and to the question whether there is a requirement that the "financial institution" or other covered entity have a beneficial interest in or dominion and control over the transferred property in order to qualify for safe harbor protection. In our view, those inquiries put the proverbial cart before the horse. Before a court can determine whether a transfer was made by or to or for the benefit of a covered entity, the court must first identify the relevant transfer to test in that inquiry. At bottom, that is the issue the parties dispute in this case.

On one side, Merit posits that the Court should look not only to the Valley View–to–Merit end-to-end transfer, but also to all its component parts. Here, those component parts include one transaction by Credit Suisse to Citizens Bank (*i.e.,* the transmission of the $16.5 million from Credit Suisse to escrow at Citizens Bank), and two transactions by Citizens Bank to Merit (*i.e.,* the transmission of $16.5 million over two installments by Citizens Bank as escrow agent to Merit). Because those component parts include transactions by and to financial institutions, Merit contends that § 546(e) bars avoidance.

FTI, by contrast, maintains that the only relevant transfer for purposes of the § 546(e) safe-harbor inquiry is the overarching transfer between Valley View and Merit of $16.5 million for purchase of the stock, which is the transfer that the trustee seeks to avoid under § 548(a)(1)(B). Because that transfer was not made by, to, or for the benefit of a financial institution, FTI contends that the safe harbor has no application.

The Court agrees with FTI. The language of § 546(e), the specific context in ***893** which that language is used, and the broader statutory structure all support the conclusion that the relevant transfer for purposes of the § 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid under one of the substantive avoidance provisions.

A

[6] [7] Our analysis begins with the text of § 546(e), and we look to both "the language itself [and] the specific context in which that language is used...." *Robinson v. Shell Oil Co.,* 519 U.S. 337, 341, 117 S.Ct. 843, 136 L.Ed.2d 808 (1997). The pertinent language provides:

> "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a ... settlement payment ... made by or to (or for the benefit of) a ... financial institution ... or that is a transfer made by or to (or for the benefit of) a ... financial institution ... in connection with a securities contract ..., except under section 548(a)(1)(A) of this title."

The very first clause—"Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title"—already begins to answer the question. It indicates that § 546(e) operates as an exception to the avoiding powers afforded to the trustee under the substantive avoidance provisions. See A. Scalia & B. Garner, Reading Law: The Interpretation of Legal Texts 126 (2012) ("A dependent phrase that begins with *notwithstanding* indicates that the main clause that it introduces or follows derogates from the provision to which it refers"). That is, when faced with a transfer that is otherwise avoidable, § 546(e) provides a safe harbor notwithstanding that avoiding power. From the outset, therefore, the text makes clear that the starting point for the § 546(e) inquiry is the substantive avoiding power under the provisions expressly listed in the "notwithstanding" clause and, consequently, the transfer that the trustee seeks to avoid as an exercise of those powers.

Then again in the very last clause—"except under section 548(a)(1)(A) of this title"—the text reminds us that the focus of the inquiry is the transfer that the trustee seeks to avoid. It does so by creating an exception to the exception, providing that "the trustee may not avoid a transfer" that meets the covered transaction and entity criteria of the safe harbor, "except" for an actually fraudulent transfer under § 548(a)(1)(A). 11 U.S.C. § 546(e). By referring back to a specific type of transfer that falls within the avoiding power, Congress signaled that the exception applies to the overarching transfer that the trustee seeks to avoid, not any component part of that transfer.

[8] Reinforcing that reading of the safe-harbor provision, the section heading for § 546—within which the securities safe harbor is found—is: "Limitations on avoiding powers." Although section headings cannot limit the plain meaning of a statutory text, see *Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.,* 554 U.S. 33, 47, 128 S.Ct. 2326, 171 L.Ed.2d 203 (2008), "they supply cues" as to what Congress intended, see *Yates v. United States,* 574 U.S. ——, ——, 135 S.Ct. 1074, 1083, 191 L.Ed.2d 64 (2015). In this case, the relevant section heading demonstrates the close connection between the transfer that the trustee seeks to avoid and the transfer that is exempted from that avoiding power pursuant to the safe harbor.

The rest of the statutory text confirms what the "notwithstanding" and "except" clauses and the section heading begin to suggest. The safe harbor provides that "the trustee may not avoid" certain transfers. § 546(e). Naturally, that text invites ***894** scrutiny of the transfers that "the trustee may avoid," the parallel language used in the substantive avoiding powers

provisions. See § 544(a) (providing that "the trustee ... may avoid" transfers falling under that provision); § 545 (providing that "[t]he trustee may avoid" certain statutory liens); § 547(b) (providing that "the trustee may avoid" certain preferential transfers); § 548(a)(1) (providing that "[t]he trustee may avoid" certain fraudulent transfers). And if any doubt remained, the language that follows dispels that doubt: The transfer that the "the trustee may not avoid" is specified to be "a transfer that *is* " either a "settlement payment" or made "in connection with a securities contract." § 546(e) (emphasis added). Not a transfer that involves. Not a transfer that comprises. But a transfer that is a securities transaction covered under § 546(e). The provision explicitly equates the transfer that the trustee may otherwise avoid with the transfer that, under the safe harbor, the trustee may not avoid. In other words, to qualify for protection under the securities safe harbor, § 546(e) provides that the otherwise avoidable transfer itself be a transfer that meets the safe-harbor criteria.

Thus, the statutory language and the context in which it is used all point to the transfer that the trustee seeks to avoid as the relevant transfer for consideration of the § 546(e) safe-harbor criteria.

B

The statutory structure also reinforces our reading of § 546(e). See *Hall v. United States,* 566 U.S. 506, 516, 132 S.Ct. 1882, 182 L.Ed.2d 840 (2012) (looking to statutory structure in interpreting the Bankruptcy Code). As the Seventh Circuit aptly put it, the Code "creates both a system for avoiding transfers and a safe harbor from avoidance—logically these are two sides of the same coin." 830 F.3d, at 694; see also *Fidelity Financial Services, Inc. v. Fink,* 522 U.S. 211, 217, 118 S.Ct. 651, 139 L.Ed.2d 571 (1998) ("Section 546 of the Code puts certain limits on the avoidance powers set forth elsewhere"). Given that structure, it is only logical to view the pertinent transfer under § 546(e) as the same transfer that the trustee seeks to avoid pursuant to one of its avoiding powers.

[9] As noted in Part I–A, *supra,* the substantive avoidance provisions in Chapter 5 of the Code set out in detail the criteria that must be met for a transfer to fall within the ambit of the avoiding powers. These provisions, as Merit admits, "focus mostly on the characteristics of the transfer that may be avoided." Brief for Petitioner 28. The trustee, charged with exercising those avoiding powers, must establish to the satisfaction of a court that the transfer it seeks to set aside meets the characteristics set out under the substantive avoidance provisions. Thus, the trustee is not free to define the transfer that it seeks to avoid in any way it chooses. Instead, that transfer is necessarily defined by the carefully set out criteria in the Code. As FTI itself recognizes, its power as trustee to define the transfer is not absolute because "the transfer identified must satisfy the terms of the avoidance provision the trustee invokes." Brief for Respondent 23.

Accordingly, after a trustee files an avoidance action identifying the transfer it seeks to set aside, a defendant in that action is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer. If a trustee properly identifies an avoidable transfer, however, the court has no reason to examine the relevance of component ***895** parts when considering a limit to the avoiding power, where that limit is defined by reference to an otherwise avoidable transfer, as is the case with § 546(e), see Part II–A, *supra*.

In the instant case, FTI identified the purchase of Bedford Downs' stock by Valley View from Merit as the transfer that it sought to avoid. Merit does not contend that FTI improperly identified the Valley View–to–Merit transfer as the transfer to be avoided, focusing instead on whether FTI can "ignore" the component parts at the safe-harbor inquiry. Absent that argument, however, the Credit Suisse and Citizens Bank component parts are simply irrelevant to the analysis under § 546(e). The focus must remain on the transfer the trustee sought to avoid.

III

A

The primary argument Merit advances that is moored in the statutory text concerns the 2006 addition of the parenthetical "(or for the benefit of)" to § 546(e). Merit contends that in adding the phrase "or for the benefit of" to the requirement that a transfer be "made by or to" a protected entity, Congress meant to abrogate the 1998 decision of the Court of Appeals for the Eleventh Circuit in *In re Munford, Inc.,* 98 F.3d 604, 610 (1996) (*per curiam*), which held that the § 546(e) safe harbor was inapplicable to transfers in which a financial institution acted only as an intermediary. Congress abrogated *Munford,* Merit reasons, by use of the disjunctive "or," so that even if a beneficial interest, *i.e.,* a transfer "for the benefit of" a financial institution or other covered entity, is sufficient to trigger safe harbor protection, it is not necessary for the financial institution to have a beneficial interest in the transfer for the safe harbor to apply. Merit thus argues that a transaction "by or to" a financial institution such as Credit Suisse or Citizens Bank would meet the requirements of § 546(e), even if the financial institution is acting as an intermediary without a beneficial interest in the transfer.

Merit points to nothing in the text or legislative history that corroborates the proposition that Congress sought to overrule *Munford* in its 2006 amendment. There is a simpler explanation for Congress' addition of this language that is rooted in the text of the statute as a whole and consistent with the interpretation of § 546(e) the Court adopts. A number of the substantive avoidance provisions include that language, thus giving a trustee the power to avoid a transfer that was made to "or for the benefit of" certain actors. See § 547(b)(1) (avoiding power with respect to preferential transfers "to or for the benefit of a creditor"); § 548(a)(1) (avoiding power with respect to certain fraudulent transfers "including any transfer to or for the benefit of an insider ..."). By adding the same language to the § 546(e) safe harbor, Congress ensured that the scope of the safe harbor matched the scope of the avoiding powers. For example, a trustee seeking to avoid a preferential transfer under § 547 that was made "for the benefit of a creditor," where that creditor is a covered entity under § 546(e), cannot now escape application of the § 546(e) safe harbor just because the transfer was not "made by or to" that entity.

Nothing in the amendment therefore changed the focus of the § 546(e) safe-harbor inquiry on the transfer that is otherwise avoidable under the substantive avoiding powers. If anything, by tracking language already included in the substantive avoidance provisions, the amendment reinforces the connection between the inquiry under § 546(e) and the otherwise ***896** avoidable transfer that the trustee seeks to set aside.

Merit next attempts to bolster its reading of the safe harbor by reference to the inclusion of securities clearing agencies as covered entities under § 546(e). Because a securities clearing agency is defined as, *inter alia,* an intermediary in payments or deliveries made in connection with securities transactions, see 15 U.S.C. § 78c(23)(A) and 11 U.S.C. § 101(48) (defining "securities clearing agency" by reference to the Securities Exchange Act of 1934), Merit argues that the § 546(e) safe harbor must be read to protect intermediaries without reference to any beneficial interest in the transfer. The contrary interpretation, Merit contends, "would run afoul of the canon disfavoring an interpretation of a statute that renders a provision ineffectual or superfluous." Brief for Petitioner 25.

[10] Putting aside the question whether a securities clearing agency always acts as an intermediary without a beneficial interest in a challenged transfer—a question that the District Court in *Seligson* found presented triable issues of fact in that case—the reading of the statute the Court adopts here does not yield any superfluity. Reading § 546(e) to provide that the relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid under a substantive avoiding power, the question then becomes whether that transfer was "made by or to (or for the benefit of)" a covered entity, including a securities clearing agency. If the transfer that the trustee seeks to avoid was made "by" or "to" a securities clearing agency (as it was in *Seligson*), then § 546(e) will bar avoidance, and it will do so without regard to whether the entity acted only as an intermediary. The safe harbor will, in addition, bar avoidance if the transfer was made "for the benefit of" that securities clearing agency, even if it was not made "by" or "to" that entity. This reading gives full effect to the text of § 546(e).

B

In a final attempt to support its proposed interpretation of § 546(e), Merit turns to what it perceives was Congress' purpose in enacting the safe harbor. Specifically, Merit contends that the broad language of § 546(e) shows that Congress took a "comprehensive approach to securities and commodities transactions" that "was prophylactic, not surgical," and meant to "advanc[e] the interests of parties in the finality of transactions." Brief for Petitioner 41–43. Given that purported broad purpose, it would be incongruous, according to Merit, to read the safe harbor such that its application "would depend on the identity of the investor and the manner in which it held its investment" rather than "the nature of the transaction generally." *Id.,* at 33. Moreover, Merit posits that Congress' concern was plainly broader than the risk that is posed by the imposition of avoidance liability on a securities industry entity because Congress provided a safe harbor not only for transactions "to" those entities (thus protecting the entities from direct financial liability), but also "by" these entities to non-covered entities. See Reply Brief 10–14. And, according to Merit, "[t]here is no reason to believe that Congress was troubled by the possibility that transfers *by* an industry hub could be unwound but yet was unconcerned about trustees' pursuit of transfers made *through* industry hubs." *Id.,* at 12–13 (emphasis in original).

Even if this were the type of case in which the Court would consider statutory purpose, see, *e.g., Watson v. Philip Morris Cos.,* 551 U.S. 142, 150–152, 127 S.Ct. 2301, 168 L.Ed.2d 42 (2007), here Merit fails to ***897** support its purposivist arguments. In fact, its perceived purpose is actually contradicted by the plain language of the safe harbor. Because, of course, here we do have a good reason to believe that Congress was concerned about transfers "*by* an industry hub" specifically: The safe harbor saves from avoidance certain securities transactions "made by or to (or for the benefit of)" covered entities. See § 546(e). Transfers "through" a covered entity, conversely, appear nowhere in the statute. And although Merit complains that, absent its reading of the safe harbor, protection will turn "on the identity of the investor and the manner in which it held its investment," that is nothing more than an attack on the text of the statute, which protects only certain transactions "made by or to (or for the benefit of)" certain covered entities.

For these reasons, we need not deviate from the plain meaning of the language used in § 546(e).

IV

[11] For the reasons stated, we conclude that the relevant transfer for purposes of the § 546(e) safe harbor is the same transfer that the trustee seeks to avoid pursuant to its substantive avoiding powers. Applying that understanding of the safe-harbor provision to this case yields a straightforward result. FTI, the trustee, sought to avoid the $16.5 million Valley View–to–Merit transfer. FTI did not seek to avoid the component transactions by which that overarching transfer was executed. As such, when determining whether the § 546(e) safe harbor saves the transfer from avoidance liability, *i.e.,* whether it was "made by or to (or for the benefit of) a ... financial institution," the Court must look to the overarching transfer from Valley View to Merit to evaluate whether it meets the safe-harbor criteria. Because the parties do not contend that either Valley View or Merit is a "financial institution" or other covered entity, the transfer falls outside of the § 546(e) safe harbor. The judgment of the Seventh Circuit is therefore affirmed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

All Citations

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Footnotes

* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

1 Avoiding powers may be exercised by debtors, trustees, or creditors' committees, depending on the circumstances of the case. See generally C. Tabb, Law of Bankruptcy § 6.1 (4th ed. 2016) (Tabb). Because this case concerns an avoidance action brought by a trustee, we refer throughout to the trustee in discussing the avoiding power and avoidance action. The resolution of this case is not dependent on the identity of the actor exercising the avoiding power.

2 The term "financial institution" is defined as:
"(A) a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a 'customer', as defined in section 741) in connection with a securities contract (as defined in section 741) such customer; or
"(B) in connection with a securities contract (as defined in section 741) an investment company registered under the Investment Company Act of 1940." 11 U.S.C. § 101(22).
The parties here do not contend that either the debtor or petitioner in this case qualified as a "financial institution" by virtue of its status as a "customer" under § 101(22)(A). Petitioner Merit Management Group, LP, discussed this definition only in footnotes and did not argue that it somehow dictates the outcome in this case. See Brief for Petitioner 45, n. 14; Reply Brief 14, n. 6. We therefore do not address what impact, if any, § 101(22)(A) would have in the application of the § 546(e) safe harbor.

3 A separate provision of the agreement providing that Bedford Downs would sell land to Valley View for $20 million is not at issue in this case.

4 In its complaint, FTI also sought to avoid the transfer under § 544(b). See App. 20–21. The District Court did not address the claim, see 541 B.R. 850, 852–853, n. 1 (N.D.Ill.2015), and neither did the Court of Appeals for the Seventh Circuit.

5 The parties do not ask this Court to determine whether the transaction at issue in this case qualifies as a transfer that is a "settlement payment" or made in connection with a "securities contract" as those terms are used in § 546(e), nor is that determination necessary for resolution of the question presented.

6 Compare *In re Quebecor World (USA) Inc.,* 719 F.3d 94, 99 (C.A.2 2013) (finding the safe harbor applicable where covered entity was intermediary); *In re QSI Holdings, Inc.,* 571 F.3d 545, 551 (C.A.6 2009) (same); *Contemporary Indus. Corp. v. Frost,* 564 F.3d 981, 987 (C.A.8 2009) (same); *In re Resorts Int'l, Inc.,* 181 F.3d 505, 516 (C.A.3 1999) (same); *In re Kaiser Steel Corp.,* 952 F.2d 1230, 1240 (C.A.10 1991) (same), with *In re Munford, Inc.,* 98 F.3d 604, 610 (C.A.11 1996) (*per curiam*) (rejecting applicability of safe harbor where covered entity was intermediary).

Committees:
Business Reorganization

Supreme Court Clarifies Power to Claw Back Transfers Made Through Financial Institutions

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A Feb. 27, 2018, decision by the U.S. Supreme Court resolved a split in the circuit courts by clarifying that a bankruptcy trustee, creditors' committee or other entity with standing may claw back preferences and constructive fraudulent transfers involving the purchase of securities, even though the transaction was effectuated by depositing funds or securities with financial institutions. The Court's decision in *Merit Management Group LP v. FTI Consulting Inc.* [1] held that § 546(e)'s safe-harbor provision requires courts to look to the transaction being challenged and determine whether the defendant in the avoidance action — the ultimate recipient of the funds — is a "covered" entity under the statute. The analysis does not focus on the constituent components of the transaction that may involve financial institutions.

Section 546(e)'s Safe Harbor

The Bankruptcy Code allows bankruptcy trustees and their successors to avoid certain pre-petition transfers by a debtor, including preferences [2] and constructive fraudulent conveyances. [3] Section 546(e) provides a safe harbor for certain types of transfers to certain enumerated, "covered" entities. These include transfers that are "settlement payment[s]" "made by or to (or for the benefit of)" a covered entity, such as a "financial institution," or transfers made to a covered entity "in connection with a securities contract." [4] The dispute was whether § 546(e) applied where A purchased securities from D, but the transaction was effectuated by intermediary transactions in which the consideration and securities were deposited in a financial institution. A typical scenario involves securities transactions where a financial institution acting as agent receives and distributes the purchase price and securities.

Prior Interpretations of § 546(e)

Prior to the *Merit Management* decision, most circuit courts interpreted § 546(e) broadly. [5] Although the plaintiff in the avoidance actions sought to claw back funds from the actual counterparty to the overall securities transaction, these courts analyzed a transaction's component parts in which cash or securities were first deposited with a bank acting as agent. [6] These courts focused on § 546(e)'s use of the phrase "by or to (or for the benefit of) a ... financial institution" and held that § 546(e) applied to protect any transaction in which funds or securities passed through a financial institution. One district court interpreted § 546(e) to apply where the buyer simply wired funds for a stock purchase from its bank account — admittedly held at a "financial institution" — to the seller's bank account — also held at a "financial institution." [7] Under this analysis, § 546(e) would immunize almost any securities transaction.

FTI Consulting Inc. v. Merit Management

Until 2016, the Eleventh Circuit was the only circuit court that took a narrower view of § 546(e). [8] In 2016, the Seventh Circuit added its voice, holding that § 546(e) applied only where the ultimate "transferee" was a covered entity, without regard to the financial intermediaries. [9] The court concluded, "We will not interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." [10]

In *FTI Consulting Inc. v. Merit Mgmt. Grp LP*, the court examined a leveraged buyout in which the debtor/purchaser first wired funds from its bank to another bank, acting as escrow agent, and the sellers deposited securities with the escrow agent. [11] The purchaser subsequently filed for bankruptcy and sought to unwind the LBO. [12] Defendants argued that the involvement of banks wiring funds or acting as escrow agents constituted protected transactions "made by or to" a financial institution, thereby immunizing the actual securities transaction between the nonfinancial institution counterparties. [13]

The Seventh Circuit rejected this argument. It held that "the economic substance" of the transaction is of primary importance, [14] and it rejected the notion that § 546(e) "covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." [15] Such an interpretation "would be so broad as to render any transfer nonavoidable unless it were done in cold hard cash...." [16] Section 546(e) applied "where the [covered] entity is a counterparty as opposed to a conduit or bank for a counterparty." [17]

The Supreme Court Decision

The Supreme Court granted *certiorari* and affirmed the Seventh Circuit. [18] The Court held that the "relevant transfer" for purposes of § 546(e) was the transaction that the trustee sought to avoid. [19] The intermediate, component or conduit transfers are not factors in determining § 546(e) safe-harbor applicability. [20] Applying its holding to the facts of the case, the Court noted that the trustee sought to avoid "the purchase of ... stock by [the debtor] from Merit...." [21] Neither of those parties were covered entities under § 546(e), therefore the safe harbor did not apply. The "component parts [of the transaction] are simply irrelevant to the analysis under § 564(e)." [22]

The Court rejected Merit's argument that its holding could have an unintended effect on certain market participants, such as a securities clearing broker. [23] If a trustee sought to avoid the transfer to the clearing broker itself, then § 546(e) would provide a safe harbor. [24]

The Effect of the Decision

The Court's decision strengthens trustees' powers to bring money into an estate by confirming that securities transactions between noncovered parties are subject to avoidance, even if the transaction is effectuated through financial institutions. The decision concurrently affirms that the safe harbor protects financial institutions acting as intermediaries, ensuring that a trustee must seek to recover funds from the actual counterparties in the transaction.

The *Merit Management* decision will likely raise new questions. Although the Court focused on "the transfer the trustee seeks to avoid," it noted that Merit did not question the trustee's decision to challenge the transaction between debtor and Merit, as opposed to the component transactions. [25] Future defendants will no doubt do so, however, so this raises the question of how much flexibility a trustee has to identify the relevant transaction for avoidance. For example, in an IPO where the underwriter initially purchases the shares and resells them to the public, can a trustee reach over the underwriter to claw back the shares from the public purchasers or their transferees? Where a financial institution is trading on its own account and not acting as an "industry hub," [26] is it entitled to the safe harbor? Finally, the Court recognized that a bank's customer can fall within the Code's definition of "financial institution." [27] As a result, it stands to reason that future transactions may be structured in a manner to take advantage of this loophole.

[1] *Merit Management Group LP v. FTI Consulting Inc.*, 583 U.S. ___, 138 S. Ct. 883 (2018).

[2] 11 U.S.C. § 547.

[3] 11 U.S.C. § 548.

[4] 11 U.S.C. § 546(e).

[5] *See Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.)*, 719 F.3d 94 (2d Cir. 2013); *QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 983, 987 (8th Cir. 2009); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 2009).

[6] *See*, *e.g.*, *Quebecor World*, 719 F.3d at 100.

[7] *U.S. Bank N.A. v. Verizon Commc'n Inc.*, 892 F. Sup. 2d 805, 814-15 (N.D. Tex. 2012).

[8] *Munford v. Valuation Research Corp. (In re Munford Inc.),* 98 F.3d 604 (11th Cir. 1996).

[9] *FTI Consulting Inc. v. Merit Mgmt. Group LP*, 830 F.3d 690 (7th Cir. 2016).

[10] *Id.* at 697.

[11] *Id.* at 691.

[12] *Id.* at 692.

[13] *Id.* at 693-94.

[14] *Id.* at 695.

[15] *Id.* at 697.

[16] *Id.* at 695.

[17] *Id.*

[18] *Merit Mgmt*., 138 S. Ct. at 898.

[19] *Id.* at 893-95. The analysis is the same whether the transaction was a "settlement payment" or in connection a "securities contract." *Id.* at 892 n.5.

[20] *Id*. at 893. The Court noted that the Bankruptcy Code allows the trustee to recover transferred property from "any immediate or mediate transferee of such initial transferee." *Id.* at 889 (citing 11 U.S.C. § 550(a)).

[21] *Id.* at 895.

[22] *Id.*

[23] *Id.* at 896.

[24] *Id*.

[25] *Id.* at 895.

[26] *Id.* at 897.

[27]*Id.* at 890, n.2.

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