AMERICAN BANKRUPTCY INSTITUTE

2019 Annual Spring Meeting

PLENARY SESSION

Judges' Hot Topics

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U.S. Bankruptcy Court (N.D. Cal.); San Francisco

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U.S. Bankruptcy Court (N.D. Ga.); Atlanta

Hon. Deborah L. Thorne
U.S. Bankruptcy Court (N.D. Ill.); Chicago

2019

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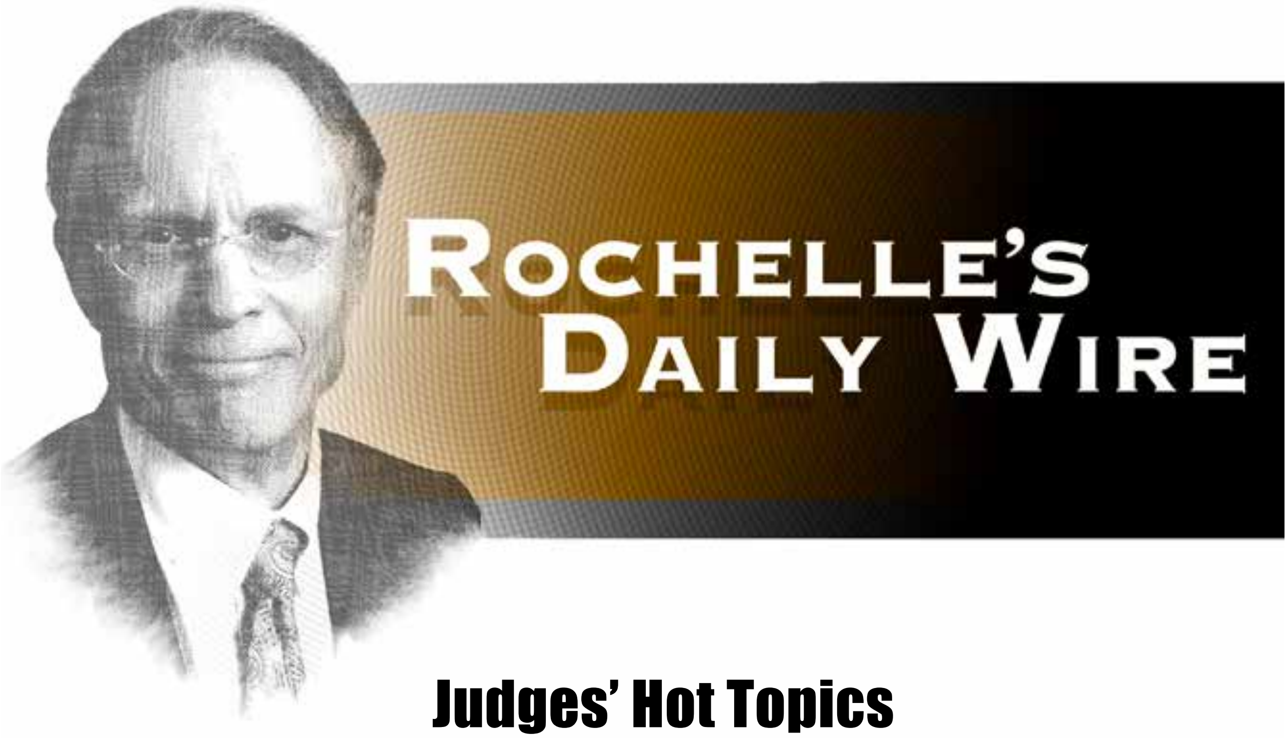

Judges' Hot Topics

ABI Annual Spring Meeting

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How Automatic Is the Automatic Stay?

The Supreme Court is invited to resolve a circuit split and decide whether inaction can violate the automatic stay.

Newly Filed *Certiorari* Petitions Raise Circuit Splits on 'Finality' and the Automatic Stay

Two newly filed petitions for *certiorari* ask the Supreme Court to decide whether (1) passively holding property of the estate violates the automatic stay under Section 362(a), and (2) an order denying a motion to modify the automatic stay is always a final order subject to appeal.

The Automatic Stay Case

The more attractive candidate for Supreme Court review is *Davis v. Tyson Prepared Foods Inc.*, 18-941 (Sup. Ct.), where the Tenth Circuit held that the automatic stay does not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 740 Fed. Appx. 163 (10th Cir. Oct. 17, 2018).

The outcome in *Davis* was governed by the Tenth Circuit's own recent authority, *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), where the Denver-based appeals court had ruled 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 circuits are split. According to the debtor seeking Supreme Court review in *Davis*, the Second, Seventh, Eighth, Ninth and Eleventh Circuits have held that passively holding estate property or passively obtaining an interest in estate property after filing violates the automatic stay. In those circuits, for example, a creditor who repossessed an auto before bankruptcy must automatically return the car after the debtor files a chapter 13 petition, on pain of contempt.

The Tenth and the District of Columbia Circuits have ruled to the contrary, holding that an affirmative action is required to underpin an automatic stay violation.

Explaining the grounds for Supreme Court review, the *certiorari* petition says there is "an entrenched and acknowledged conflict among the courts of appeals" on a question that is "a vitally important and recurring issue of federal law."

The *certiorari* petition for the debtor was filed by G. Eric Brunstad, Jr., who has argued 10 cases in the Supreme Court.

The response to the petition for *certiorari* is due on February 19. If the high court grants the petition, the case would not be argued until the term to begin in October 2019.

The same issue is coming to the Seventh Circuit on direct, consolidated appeals, from decisions by bankruptcy judges in Chicago who ruled that the city must turn over impounded cars automatically when the owners file chapter 13 petitions. The appeals court entered a scheduling order calling for the last brief to be filed on February 19.

If Chicago loses in the Seventh Circuit, the city is likely to file a *certiorari* petition to argue there is no stay violation by continuing to hold an impounded vehicle. If the Supreme Court denies *certiorari* to the Tenth Circuit, the case from the Seventh Circuit could be a better vehicle to decide the extent to which the automatic stay is automatic. The consolidated appeal in the Seventh Circuit is *City of Chicago v. Fulton*, 18-2527 (7th Cir.).

To read ABI's discussion of the Tenth Circuit's *Davis* opinion, click here. To read about the circuit's predecessor opinion, *Cowen*, click here. For some of ABI's reporting on the Chicago parking-ticket cases, click here.

The 'Finality' Case

The petition for *certiorari* in *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.), asserts that the Sixth Circuit deepened an existing circuit split by erroneously holding that an order denying a motion to modify the automatic stay is always a final order that must be appealed immediately.

The case in the Sixth Circuit involved a motion to lift the automatic stay, which was denied in bankruptcy court. The creditor who lost the motion did not appeal within 14 days.

Instead, the creditor filed an appeal from the denial of the lift-stay motion months later when the bankruptcy judge sustained the debtor's objection to the creditor's claim. In October, the Sixth Circuit upheld the district judge who had dismissed the appeal for being untimely. *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry, LLC)*, 906 F.3d 494 (6th Cir. Oct. 16, 2018),

The Sixth Circuit cited five other circuits and the *Collier* treatise for saying that courts "almost uniformly" hold that denial of a lift-stay motion is an appealable order. However, the appeals court went on to lay down a two-part rule to determine whether any order is final and therefore appealable.

Extrapolating from the governing statute, 28 U.S.C. § 158(a), the Sixth Circuit said that an order is final if it was entered in a "proceeding" and if the order terminated that proceeding. Because a lift-stay motion is a core "proceeding," denial of motion was final because it was

procedurally complete and precluded the creditor from pursuing its claim against the debtor outside of bankruptcy court, citing *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015).

The petitioner for *certiorari* argues there is a split of circuits, because eight circuits (including the Sixth) hold that orders denying lift-stay motions "are categorically appealable." On the other hand, the petitioner claims that the First and Third Circuits take a flexible approach by saying that denying a modification of the stay sometimes may not be final.

The petitioner contends that the Sixth Circuit misapplied *Bullard* and *Gillespie v. U.S. Steel Corp.*, 379 U.S. 148, 152 (1964). In *Gillespie*, the petitioner says, the Supreme Court said that finality is sometimes a "close question" and that it is "impossible to devise a formula to resolve all marginal cases."

The petitioner may have a point. The Sixth Circuit did establish a seemingly rigid, two-part test for all cases, arguably at odds with *Gillespie*. However, the Sixth Circuit may have correctly applied *Bullard* and *Gillespie* in the case at hand. In *Bullard*, the high court ruled that an order denying confirmation of a chapter 13 plan was not a final, appealable order because denying confirmation did not terminate the proceeding, unlike denial of a lift-stay motion.

The response to the *certiorari* petition is due on February 19. Argument would be held in the term to begin in October 2019 if the petition is granted.

The *certiorari* petitions are *Davis v. Tyson Prepared Foods Inc.*, 18-941 (Sup. Ct.), and *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.).

Circult split is widening on whether inaction can be a violation of the automatic stay.

Tenth Circuit Opinion Can Be the Springboard for a '*Cert*' on the Automatic Stay

Predictably, the Tenth Circuit reaffirmed a deepening circuit split yesterday by holding that the automatic stay does not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. Yesterday's ruling sets up an opportunity for the Supreme Court to resolve the split and decide whether the automatic stay is really automatic.

Yesterday's decision in *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir. Oct. 17, 2018), was a foregone conclusion given *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), where the Tenth Circuit held last year 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."

As the Tenth Circuit said yesterday, *Cowen* means that an "'act' for the purposes of [Section] 362(a)(3) is limited to affirmative conduct." The appeals court said that the automatic stay did not apply in *Garcia* because the "subrogation lien arose solely by operation of law."

In the lower court in *Garcia*, Bankruptcy Judge Robert E. Nugent of Wichita, Kan., reluctantly held, contrary to two prior decisions of his own, that the automatic stay did not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. Judge Nugent certified the case for direct appeal, and the circuit accepted the invitation.

The circuit court's decision in *Garcia* allows the lien to attach automatically despite the policy in Section 552(a), which precludes a "security interest" from attaching to property acquired after filing, with exceptions.

According to the transcript of oral argument in *Garcia* on September 26, the three-judge panel did not seem receptive to the idea of rehearing *en banc*, which would allow the Tenth Circuit to revisit *Cowen*. If the trustee in *Garcia* is bent on further appellate review, he may opt for filing a petition for *certiorari* and bypass an attempt at rehearing *en banc*.

The Tenth Circuit is in accord with the District of Columbia Circuit in holding that inaction does not violate the automatic stay. The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold to the contrary, having ruled that a lender or owner must turn over repossessed property immediately or face a contempt citation.

At present, there is a race to decide whether a decision by the Tenth Circuit or Seventh Circuit will arrive first in the Supreme Court. In Chicago, some but not all bankruptcy judges have held that the city must automatically turn over automobiles that were impounded before bankruptcy on account of unpaid parking fines. The Seventh Circuit accepted a direct, consolidated appeal. The last brief is due in the Seventh Circuit on December 31. Consequently, the trustee in *Garcia* may end up filing the first *certiorari* petition.

To read some of ABI's coverage of *Cowen*, *Garcia*, and the Chicago cases, click here, here, here, here, and here.

The new Tenth Circuit opinion is *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir. Oct. 17, 2018).

What Is a Payment 'Provided For' in a Plan?

By implication, the Eleventh Circuit would allow a general chapter 13 discharge to a debtor who defaults on direct mortgage payments, an issue where lower courts are split.

Direct Mortgage Payments Are Not 'Provided For' in a Plan, Eleventh Circuit Holds

For the first time among the courts of appeals, two judges on an Eleventh Circuit panel held that direct payments by a chapter 13 debtor to a mortgagee are not "provided for by the plan" under Section 1328(a), even if the plan says the payments will be made directly.

However, all three judges agreed that a general chapter 13 discharge did not eliminate the debtor's personal liability for a deficiency on a home mortgage.

The majority's December 6 opinion by Circuit Judge Julie Carnes means that chapter 13 debtors with direct mortgage payments may have lost a battle, but they could have won a larger war.

Whether direct mortgage payments are made under a plan has greater significance in a related context. A chapter 13 debtor who has made "all payments under the plan" is entitled to a discharge under Section 1328(a). If the Eleventh Circuit's holding with respect to debts "provided for by the plan" also applies to "all payments under the plan," then a chapter 13 debtor who has defaulted on direct mortgage payments would still be entitled to a chapter 13 discharge shedding other debts that *were* provided for in the plan.

On the question of a general chapter 13 discharge, the lower courts are split on whether failure to make direct mortgage payments bars a chapter 13 debtor's general discharge. For example, click here to read ABI's discussion of *Simon v. Finley (In re Finley)*, 18-4011, 2018 BL310219 (Bankr. S.D. Ill. Aug. 28, 2018), showing how the bankruptcy courts in Illinois disagree on giving a discharge to a chapter 13 debtor who missed direct mortgage payments.

The Facts

The debtor filed a chapter 13 petition and confirmed a three-year plan. The debtor's home mortgage was current on filing. The plan specifically provided that the debtor would continue making direct payments to the holder of the mortgage and would not route mortgage payments through the chapter 13 trustee, thus avoiding the fee that the trustee would charge.

Shortly after filing, the debtor filed a motion seeking authority to make mortgage payments directly. The order granting the motion terminated the automatic stay as to the mortgage by permitting the mortgagee to seek *in rem* relief against the property if there were a default.

Over the life of the plan, the debtor made total payments of about $5,700, including some $3,600 earmarked for creditors. None of the debtor's payments were for the mortgagee.

According to Judge Carnes, the plan did not specify repayment terms for the mortgage, did not contain a schedule of payments, and did not make any alterations to the mortgage.

About one year after confirmation, the debtor stopped making mortgage payments. However, the debtor made all payments to the trustee and received her chapter 13 discharge.

Meanwhile, the mortgagee foreclosed the home and sought a deficiency judgment against the debtor. A year after discharge, the mortgagee reopened the chapter 13 case and filed suit for a declaration that the debtor's personal liability for a deficiency on the mortgage had not been discharged.

Upheld in district court, Bankruptcy Judge Caryl E. Delano of Tampa, Fla., granted summary judgment in favor of the lender, holding that the deficiency was not discharged.

The debtor appealed to the circuit court, to no avail.

'Provided For By'

Once a debtor completes all payments "under the plan," the last phrase in Section 1328(a) gives a discharge for "all debts provided for by the plan." The debtor thus argued on appeal that the unsecured deficiency claim was discharged because the mere mention of the mortgage in the plan meant it was "provided for by the plan."

Judge Carnes disagreed. To be "provided for," she said, the plan "must, in some way, affect or govern the debtor's repayment."

Although the issue has not percolated to the courts of appeals, Judge Carnes cited three lower court decisions that she characterized as saying that "a plan's mere statement that payments on a debt will be made outside of the plan does not mean that debt is 'provided for' by the plan."

Judge Carnes buttressed her conclusion by citing *Rake v. Wade*, 508 U.S. 464 (1993), where the Supreme Court interpreted "provided for" as it appears in Section 1325(a)(5). In *Rake*, the high court said that "provided for" means "to 'make a provision for' or 'stipulate to' something in the plan." *Id*. at 473.

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Because the plan made no provision for the mortgage, Judge Carnes said it was not “provided for,” meaning that the deficiency claim was not discharged.

Even if the mere mention of the mortgage meant it was “provided for,” Judge Carnes ruled that discharging the deficiency claim would violate the antimodification provision in Section 1322(b)(2), which prohibits a chapter 13 plan from modifying a claim secured only by the debtor’s principal residence.

In essence, depriving the mortgagee of the ability “to pursue *in personam* liability against [the debtor] . . . would necessarily modify the [mortgagee’s] rights because it strips the [lender] of a right provided by the original loan instruments,” Judge Carnes said.

Finally, the debtor argued that the unsecured deficiency claim was discharged because the lender did not file a proof of claim.

The debtor waived the argument, Judge Carnes said, because she raised it for the first time on appeal.

“Even if we were to consider this,” Judge Carnes said, “the merits favor” the lender.

Even without a proof of claim, Judge Carnes said, the deficiency liability “passed through bankruptcy unaffected” because it was “nondischargeable under the antimodification provision.”

The Implications of the Decision

Being “provided for” in the plan, or not, has another significance: A debtor is entitled to a chapter 13 discharge under the first phrase in Section 1328(a) after completing “all payments under the plan.” As we said earlier, the lower courts are split on whether defaulting on direct mortgage payments deprives a debtor of a general chapter 13 discharge, even if the debtor has spent five years religiously making all other payments through the trustee.

It is not a foregone conclusion that Judge Carnes’ opinion interpreting “provided for” in the last phrase of Section 1328(a) also governs “payments under the plan” appearing in the first phrase of the section. Does the subtle difference in language convey an entirely different meaning?

Judge Carnes did not miss the issue. In footnote 8, she appeared to say that the debtor would not have been entitled to a discharge under the first phrase in the section if the direct payments were under the plan.

Although the decision is not controlling, the opinion by Judges Carnes should carry weight in the Eleventh Circuit (and perhaps elsewhere) when a debtor wants a general chapter 13 discharge despite having defaulted on direct mortgage payments.

The Concurring Opinion

Circuit Judge Jill Pryor concurred in the judgment, but her separate opinion undercuts the majority's analysis on "provided for by the plan" that would be helpful for a debtor seeking a general discharge after defaulting on direct mortgage payments.

Judge Pryor agreed with the majority's alternative holding that the antimodification provision in Section 1322(b)(2) by itself bars the debtor from discharging a deficiency judgment.

Judge Pryor said she would have affirmed on that basis alone and would not have reached the question of whether the mortgage was "provided for by the plan."

The opinion is *Dukes v. Suncoast Credit Union (In re Dukes)*, 16-16513 (11th Cir. Dec. 6, 2018).

Illinois judges disagree on whether direct payments to a mortgagee are "under the plan" and must be made in full to obtain a chapter 13 discharge.

Judges Split on Denial of Chapter 13 Discharge for Missing Direct Mortgage Payments

Bankruptcy judges in Illinois disagree on whether a chapter 13 debtor who fails to make all direct payments on a home mortgage is eligible for a discharge.

Adopting the minority approach, Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., ruled in March that failure to make direct payments on a nondischargeable mortgage is not grounds for denying a chapter 13 discharge. To read ABI's discussion of Judge Perkins' opinion, *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. March 5, 2018), click here.

Chief Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., confronted a similar case where the confirmed chapter 13 plan called for the debtors to make direct payments to the home mortgage lender going forward. Payments through the trustee cured arrears.

At the end of the plan, the trustee filed a notice saying that the arrears had been cured and that the debtors had made all payments required to be made to the trustee. The debtors filed a motion for entry of discharge, stating they had made all payments required by the plan.

Fifteen days before the deadline for objecting to discharge, the mortgage lender filed a response to the trustee's notice stating that the mortgage was in arrears by almost $71,000. The lender did not object to the entry of discharge, perhaps because the mortgage debt would not be discharged in any event under Sections 1322(b)(5) and 1328(a)(1).

Neither the chapter 13 trustee nor any creditor objected, so Judge Grandy entered the debtor's discharge under Section 1328(a).

One month after the entry of discharge, the chapter 13 trustee filed a complaint to revoke discharge under Section 1328(e), alleging that the debtors had obtained their discharges by fraud. The debtors' counsel argued that the motion for a discharge was accurate because direct payments allegedly were not "under the plan."

Judge Grandy said in her August 28 opinion that she "respectfully" disagrees with Judge Perkins because she believes that direct payments to a mortgagee are "payments under the plan," as required by Section 1328(a). Direct payments are "under the plan," she said, because they "must be addressed in that plan."

However, Judge Grandy did not revoke the debtors' discharges. Because the lender's response told the chapter 13 trustee in advance of discharge that the debtors had not made all payments, she allowed the discharge to stand under Section 1328(e) because the trustee knew about the alleged fraud before discharge.

Given the trustee's tardy objection to discharge, Judge Grandy said it was unnecessary to decide "whether or not the debtors' statement that they completed all plan payments was fraudulent."

She ended her opinion with an admonition, saying it was "entirely possible that such statements may rise to the level of fraud." Therefore, she said, debtors "are advised to carefully consider the accuracy and truthfulness of statements made in their motions for discharge."

The opinion is *Simon v. Finley (In re Finley)*, 18-4011 (Bankr. S.D. Ill. Aug. 28, 2018).

Chapter 11 Plan Confirmation Strategies

To warrant 'designation,' a claim purchaser must have an 'ulterior motive' beyond self-interest.

Buying Just Enough Unsecured Claims to Defeat Confirmation Is Ok, Ninth Circuit Says

Buying barely enough unsecured claims to defeat confirmation of a plan is not reason in itself for barring a secured creditor from voting the purchased claims against confirmation of a chapter 11 plan, according to the Ninth Circuit.

In *Figter Ltd. v. Teachers Ins. & Annuity Association of America (In re Figter)*, 118 F.3d 635, 639 (9th Cir. 1997), the Ninth Circuit ruled that a secured creditor was entitled to vote unsecured claims against confirmation of a chapter 11 plan when the lender had purchased all the claims in the class. In his June 4 opinion, Ninth Circuit Judge N. Randy Smith expanded *Figter* by ruling emphatically that a secured creditor is not in bad faith by purchasing just enough claims to defeat confirmation, thereby adversely affecting other creditors.

Owed about $4 million, the secured creditor spent $13,000 on advice of counsel to purchase just over half in number of the chapter 11 debtor's unsecured claims. The purchased claims represented only 10% of the unsecured class in amount.

The lender's counsel testified that the client made no attempt at purchasing all unsecured claims. The client's motivation, the lawyer said, was to acquire a blocking position and do what was best for the lender.

Although the debtor had the required two-thirds vote in amount in the unsecured class to confirm the plan, the debtor was facing defeat because a majority in number of unsecured creditors were not voting in favor of the plan as required by Section 1126(c). The plan would pay unsecured creditors in full in a few months.

The debtor moved to "designate" the unsecured claims purchased by the lender under Section 1126(e), which provides that the court "may designate any entity whose acceptance or rejection of such plan was not in good faith . . . ." In substance, "designate" means to disallow voting.

The bankruptcy court designated the claims and later confirmed an amended version of the plan. Judge Smith said that the bankruptcy court based designation on just two facts: (1) the lender did not offer to purchase all unsecured claims, and (2) voting the purchased claims against the plan would give the lender an "unfair advantage" and would be "highly prejudicial" to other creditors.

The district court affirmed, but the Ninth Circuit reversed.

Judge Smith said that the Bankruptcy Code does not define "good faith" as used in Section 1126(e). *Figter*, he said, defined "bad faith" as an attempt to "secure some untoward advantage over other creditors for some ulterior purpose." Judge Smith quoted *Figter* as holding that designation applies to creditors who were "'not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled.'"

According to *Figter*, "bad faith explicitly does not include 'enlightened self-interest, even if it appears selfish to those who do not benefit from it,'" Judge Smith said. Therefore, purchasing claims to obtain a blocking provision and to protect a creditor's own claim "does not demonstrate bad faith or an ulterior motive," *Figter* held.

Purchasing all unsecured claims was only one factor prompting the *Figter* court to find good faith, Judge Smith said. He cited Second Circuit authority for the proposition that purchasing claims to block a plan is not bad faith in itself.

Judge Smith faulted the bankruptcy court for not analyzing the lender's motivation and failing to identify an "ulterior motive." Citing *Figter*, he said that self-interest and ulterior motive are not identical. Ulterior motive is attempting to obtain a benefit to which the creditor is not entitled, Judge Smith said, again citing *Figter*.

Examples of bad faith, according to Judge Smith, include purchasing a claim to block a lawsuit against the purchaser or buying claims to destroy a competitor's business. "There must be some evidence beyond negative impact on other creditors," Judge Smith said.

In sum, the bankruptcy court erred by making no findings about the lender's motivation and by considering the effect on other creditors without evidence of bad faith.

The opinion is *Pacific Western Bank v. Fagerdala USA-Lompoc Inc. (In re Fagerdala USA-Lompoc Inc.)*, 16-35430 (9th Cir. June 4, 2018).

Narrow reading of 'equitable mootness' in* Tribune *is limited to cases involving a dispute between two classes.

Delaware District Judge Upholds Horizontal 'Gifting' in a Chapter 11 Plan

To no one's surprise, a district court in Delaware held that so-called horizontal gifting does not offend the chapter 11 confirmation standards.

In his August 21 opinion, District Judge Richard G. Andrews reached the merits of gifting after ruling that the appeal from confirmation was equitably moot.

The debtor had $500 million in secured debt and a business concededly not worth more than $300 million. The prepackaged chapter 11 plan called for converting secured debt to equity. The secured creditors made what is known as a gift to unsecured creditors in the form of cash and stock to holders of unsecured notes worth no more than 6% of the claims in the class. Trade and other unsecured creditors were to be paid in full.

The noteholder class voted against the plan, but Bankruptcy Judge Kevin J. Carey confirmed the plan last year. A holder of about $500,000 in unsecured notes appealed from the confirmation order and unsuccessfully sought a stay pending appeal.

The noteholder argued that the appeal was not equitably moot because the appellate court could order payment of its claim in full without upsetting the plan as a whole.

Judge Andrews rejected the argument, saying there was no method under the Bankruptcy Code to permit paying the appellant in full without paying all other noteholders in full. Paying one creditor in the noteholder class, he said, would offend Section 1123(a)(4) and its requirement of making identical payments to all creditors in a class.

Judge Andrews declined to expand *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. Aug. 19, 2015), where the Third Circuit declined to dismiss an appeal for equitable mootness because it would not be unfair if one class were forced to pay back $30 million.

Even if he could pay one noteholder and not the others, Judge Andrews said it was "unclear which party the court may order to fund such a recovery." He distinguished *Tribune* by saying it was an intercreditor dispute involving a reallocation between two classes that would not upset the overall plan. Unlike *Tribune*, he said there was no readily identifiable set of creditors against whom disgorgement could be ordered.

Judge Andrews concluded that the appeal was equitably moot because he could not give the appellant a higher recovery than other noteholders "within the confines of the Bankruptcy Code"; paying noteholders the same as trade creditors "would require undoing the plan and would necessarily harm third parties"; and there was no other "practicable relief" the court could grant.

Although finding the appeal to be equitably moot, Judge Andrews analyzed the merits and upheld confirmation.

The appealing noteholder argued that the plan unfairly discriminated and thus violated Section 1129(b)(1).

Like Delaware District Judge Gregory M. Sleet in *Law Debenture Trust Co. of New York v. Tribune Media Co. (In re Tribune Media Co.)*, 12-1072, 2018 BL 269729 (D. Del. July 30, 2018), Judge Andrews applied the so-called Markell test to determine whether there was unfair discrimination. The test raises a rebuttable presumption of unfair discrimination if a similar class receives "a materially lower percentage recovery." To read ABI's discussion of *Tribune Media*, click here.

Although Judge Andrews noted that the Markell test says nothing about gifting, he said the bankruptcy court properly applied the test and found no improper discrimination. He said that *In re Genesis Health Ventures Inc.*, 280 B.R. 339 (D. Del. 2002), presented "virtually identical facts" involving horizontal gifting, where a senior creditor makes a gift to an inferior class.

Judge Andrews said that *Genesis I* found that gifting rebuts the presumption of unfair discrimination when senior lenders redirect a portion of the recovery to which they otherwise would have been entitled.

Judge Andrews also ruled that the appealing noteholder was not harmed as a consequence of the larger recovery by trade creditors because "all unsecured creditors did significantly better than they would have outside of chapter 11 or under a plan of liquidation."

Judge Andrews said that the case on appeal was not a prohibited form of so-called vertical class-skipping because there was no distribution to a class junior to the bondholders.

The opinion is *Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.)*, 17-1024 (D. Del. Aug. 21, 2018).

Circuit Split on the New Value Defense

Bankruptcy judge reluctantly follows precedent where the Seventh Circuit is in the minority on the new value defense.

Chicago Case May Resolve the Circuit Split on the New Value Defense

A case gestating in the Chicago bankruptcy court may lead to a petition for *certiorari* and a definitive ruling from the Supreme Court to say whether new value must remain unpaid on the filing date to qualify as a defense to a preference.

The Circuit Split

In August, the Eleventh Circuit said that its prior decision on the new value defense was *dicta*. Therefore, the three-judge panel had the ability to override the appeals court's previous statement and hold that new value need not remain unpaid to qualify as a defense to a preference. *Kaye v. Blue Bell Creameries Inc. (In re BFW Liquidation LLC)*, 899 F.3d 1178 (11th Cir. Aug. 14, 2018). For ABI's discussion of *BFW*, click here.

In *BFW*, the Eleventh Circuit joined the Fourth, Fifth, Eighth and Ninth Circuits, which do not limit the new value defense to subsequent advances of credit remaining unpaid on the filing date. In her opinion for the Atlanta-based appeals court, Circuit Judge Julie E. Carnes said that "the Seventh Circuit held, without much discussion, that Section 547(c)(4) does require new value to remain unpaid."

The Chicago Case

Situated in the Seventh Circuit, Bankruptcy Judge LaShonda A. Hunt of Chicago faced the unenviable task of ruling on a case where her circuit is in the minority.

A chapter 7 trustee sued a creditor to recover a $3 million preference. The parties agreed that the creditor had a valid new value defense for about $1.4 million, representing sequent advances that were unpaid. However, they disagreed on allowing the creditor an additional defense arising from some $800,000 in other new value that the debtor did pay before filing.

The case before Judge Hunt turned on the new value defense in Section 547(c)(4)(B), which allows a creditor to offset "new value" given after a preferential transfer that was "(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

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Judge Hunt acknowledged that the Seventh Circuit is in the minority on the circuit split. Naturally, she said, "this court must follow the decisions of that higher court," meaning the Seventh Circuit.

Judge Hunt therefore followed *In re Prescott*, 805 F.2d 719 (7th Cir. 1986), by granting the trustee partial summary judgment on the applicable law and holding that the creditor was not entitled to the new value defense for subsequent advances that the debtor paid before filing.

Still, Judge Hunt seemed less than enthusiastic about her decision. She said that the "statutory language . . . plausibly could be read as the majority of the Circuits have done . . . ." She also identified "interesting policy considerations" supporting the majority's conclusions. She was alluding to the notion that the new value defense is intended to encourage creditors to continue advancing credit to financially distressed customers.

The decision is not a final order and not yet appealable, because Judge Hunt only granted partial summary judgment.

Big bucks are involved. The creditor is the U.S. branch of a huge multinational corporation able to afford an appeal to the Seventh Circuit and a subsequent petition for rehearing *en banc* or *certiorari*. Let's hope there's no settlement, so the Supreme Court can resolve the circuit split by drawing the boundaries of the new value defense.

The opinion is *Steege v. Canon USA Inc. (In re Calumet Photographic Inc.)*, 16-00195 (Bankr. N.D. Ill. Jan. 9, 2019).

Eleventh Circuit abandons the notion that new value must remain unpaid to offset a preference.

Circuit Split Narrows on the New Value Defense to a Preference

Narrowing a split among the circuits, the Eleventh Circuit no longer requires that new value remain unpaid on filing to qualify as a defense to a preference.

As it now stands, the Fourth, Fifth, Eighth, Ninth and Eleventh Circuits do not limit the new value defense to subsequent advances of credit that remain unpaid on the filing date. According to the August 14 opinion by Eleventh Circuit Judge Julie E. Carnes, "the Seventh Circuit held, without much discussion, that Section 547(c)(4) does require new value to remain unpaid."

Similarly, she said that the Third Circuit "also stated in a conclusory fashion [in *dicta*] that Section 547(c)(4) requires new value to remain unpaid."

In reality, the Eleventh Circuit was not reversing a prior holding. Judge Julie Carnes, not to be confused with Chief Judge Ed Carnes, said that her court's prior statement in *Charisma Investment Company N.V. v. Airport Systems Inc. (In re Jet Florida System Inc.)*, 841 F.2d 1082 (11th Cir. 1988), was *dicta* and therefore was not binding.

Commenting on Judge Carnes' opinion, Charles Tatelbaum of Miami told ABI, "It's about time."

The Facts in the Eleventh Circuit

The appeal to the Eleventh Circuit involved a typical preference, albeit for big bucks. The supplier to a chain of grocery stores was paid more than $550,000 in the 90-day preference period before bankruptcy. Also during the preference period, the supplier provided new value by delivering goods worth some $435,000.

The supplier conceded that the payments satisfied all of the elements of a preference under Section 547(b).

However, the supplier raised the so-called ordinary course defense under Section 547(c)(2) and the new value defense under Section 547(c)(4). The bankruptcy court rejected the ordinary course defense.

Relying on *Jet Florida*, the bankruptcy court did not allow the supplier to offset new value that the debtor had paid before filing. As a result, the bankruptcy court held the supplier liable for a net of about $440,000 in preferences. Had the defense been allowed, it is possible that the supplier may have had no preference liability at all.

The bankruptcy court certified a direct appeal, which the Eleventh Circuit accepted. The supplier only raised the new value defense on appeal.

Jet Florida's *Dicta*

In *Jet Florida*, the creditor had raised the new value defense under Section 547(c)(4), which allows a creditor to offset "new value" given after a preferential transfer that was "(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

The bankruptcy court in *Jet Florida* concluded that the creditor had not given new value as a matter of fact. Agreeing that the creditor had not given new value, the circuit court in *Jet Florida* upheld the finding of a preference.

In the course of the decision, however, the Eleventh Circuit said that the new value defense has "generally been read to require . . . that the new value must remain unpaid." *Id.* at 1083.

Because the statement about remaining unpaid was not necessary to the decision in *Jet Florida*, Judge Carnes said it was *dicta* and was therefore not binding on the court.

Plain Language Saves the Supplier

Analyzing the issue anew, Judge Carnes said that the "plain language" of Section 546(c)(4) "does not require new value to remain unpaid." She also said that "policy considerations strongly disfavor the trustee's position" that new value must remain unpaid to provide an offset to a preference.

Judge Carnes found nothing in the language of Section 546(c)(4) allowing an offset "only for new value that remains unpaid." Instead, she said, the "plain language" in subsections (A) and (B) allow the defense "so long as the transfer that pays for the new value is itself avoidable."

Judge Carnes buttressed her conclusion by analyzing the history of preferences. Under the predecessor to the current preference statute, Section 60c of Bankruptcy Act of 1898 said there was an offset for "such new credit remaining unpaid." The "remaining unpaid" language, she said, was omitted from the Bankruptcy Code, to be replaced by "something substantively different" in the confusing double negatives now found in subsections (A) and (B).

Judge Carnes cited the Commission on the Bankruptcy Laws of the U.S. for recommending before adoption of the Code that the "remaining unpaid" provision be eliminated.

Even if Congress had not intended to make a change from prior law, Judge Carnes said she would reach the same conclusion from "the unambiguous statutory language."

Policy Considerations Point in the Same Direction

Requiring new value to remain unpaid "would hinder the policy objective of encouraging vendors to continue extending credit to financially troubled debtors," Judge Carnes said. Otherwise, a supplier who senses financial trouble would have a "strong disincentive" to continue delivering goods, for fear that preference liability would increase.

Judge Carnes described a hypothetical where a supplier received $5,000 in payments and made $5,000 in advances during the preference period. If "remaining unpaid" were a requirement, the supplier would be liable for the entire $5,000. If it did not matter, the supplier's maximum liability would be $1,000, she said.

Giving suppliers incentives to cut off customers in financial trouble would hasten bankruptcy, while harming both the debtor and other creditors, Judge Carnes said.

The trustee made a virtually unintelligible argument based on the word "otherwise" in subsection (B). Judge Carnes said that no court had accepted the argument and some have rejected it.

Judge Carnes remanded the case to recalculate the amount of the preference, if any, for which the supplier would be liable.

The opinion is *Kaye v. Blue Bell Creameries Inc. (In re BFW Liquidation LLC)*, 17-13588 (11th Cir. Aug. 14, 2018).

Will the Supreme Court Take the Fangs Out of Contempt for Stay Violations?

Supreme Court has three bankruptcy cases this term, on nonjudicial foreclosure, trademark rejection, and contempt for a stay violation.

Supreme Court Grants '*Cert* to Decide Whether Good Faith Is a Defense to Contempt

On Friday afternoon, the Supreme Court granted *certiorari* in *Taggart v. Lorenzen*, 18-489 (Sup. Ct.), to decide whether good faith is a defense to a violation of the discharge injunction. The grant of *certiorari* means that the Supreme Court again will have at least three bankruptcy cases on the calendar this term.

The high court agreed to review *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018, *rehearing denied* Sept. 7, 2018), where the Ninth Circuit held that a subjective, good faith belief that an action does not violate the discharge injunction absolves the creditor of contempt, even if the belief is "unreasonable." To read some of ABI's coverage of *Taggart*, click here.

Taggart will resolve a split of circuits. Five weeks after *Taggart*, the First Circuit held in *IRS v. Murphy*, 892 F.3d 29 (1st Cir. June 7, 2018), that good faith is not a defense to contempt of the discharge injunction. To read ABI's discussion of *Murphy*, click here.

In the first bankruptcy case this term, the Supreme Court is hearing oral argument today in *Obduskey v. McCarthy & Holthus LLP*, 17-1307 (Sup. Ct.), also to resolve a circuit split and decide whether the federal Fair Debt Collection Practices Act applies to nonjudicial foreclosures. ABI will report on oral argument.

In late October, the Supreme Court granted *certiorari* in *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct.), to resolve a split of circuits and decide whether rejection of a trademark license bars the licensee from continuing to use the mark. Oral argument in *Mission Product* is scheduled for February 20. To read some of ABI's coverage of *Mission Product*, click here.

In both *Obduskey* and *Taggart*, Daniel L. Geyser of Dallas will argue in the Supreme Court on behalf of the debtors. The trademark licensee is being represented in *Mission Product* by Danielle Spinelli of Wilmer Cutler Pickering Hale & Dorr LLP. Ms. Spinelli is a former Supreme Court clerk who argued on the winning side in two recent bankruptcy cases, *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

Oral argument in *Taggart* will be held before the end of April, allowing the justices to issue a ruling before the Court's term ends in late June.

The stay-violation case in the Supreme Court is *Taggart v. Lorenzen*, 18-489 (Sup. Ct.).

Rochelle's Daily Wire

100% Chapter 13 Plans

'Value' doesn't mean 'present value' in Section 1325(b)(1)(A), Judge Lorch says.

Courts Split over Interest on Unsecured Claims in 100% Chapter 13 Plans

On an issue where the lower courts are about evenly divided, Bankruptcy Judge Basil H. Lorch, III of Evansville, Ind., ruled that a chapter 13 debtor who is not devoting all disposable income to the plan can confirm the plan by paying unsecured creditors in full, *without interest*.

The debtor would have disposable income of more than $80,000 over the course of the proposed five-year plan. Timely filed proofs of unsecured claims amounted to some $17,000, and payments under the plan would total about $51,000. Although the chapter 13 plan would pay unsecured claims in full, the debtor was not proposing to pay interest on unsecured claims.

The chapter 13 trustee objected to confirmation, contending that Section 1325(b)(1) requires interest on unsecured claims. The trustee argued that the statutory language in subsection (b)(1), "as of the effective date of the plan," modifies the word "value" in subsection (b)(1)(A) to mean that the plan must pay the present value of the claims and therefore includes interest.

Also relying on Section 1325(b)(1), the debtor contended that unsecured creditors are not entitled to interest. The debtor interpreted the quoted language as modifying both subsections (A) and (B) by specifying the date when the court must make the calculation.

Listing decisions coming down on both sides, Judge Lorch said in his September 13 opinion that the courts are "equally divided." The *Norton* and *Collier* treatises take opposite positions on the outcome, with *Collier* on the debtor's side.

Judge Lorch adopted the approach of Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., in *In re Gillen*, 568 B.R. 74 (Bankr. C.D. Ill. 2017). To read ABI's discussion of *Gillen*, click here.

Like Judge Perkins, Judge Lorch believes that "as of the effective date of the plan" would have appeared immediately after "value" if Congress had intended for plans to pay the present value of unsecured claims.

Also like Judge Perkins, Judge Lorch observed that unsecured creditors in chapter 13 have no right to immediate payment at the beginning of the case, unlike secured creditors or even unsecured creditors in solvent chapter 7 cases.

Requiring interest on unsecured claims would produce an "anomalous result," Judge Lorch said, because Section 1322(a)(2) permits deferred payments on priority claims without interest.

Rochelle's Daily Wire

The opinion is *In re McKinney*, 18-70417 (Bankr. S.D. Ind. Sept. 13, 2018).

Substantive Consolidation

Seventh Circuit is averse to creating remedies under Section 105, Bankruptcy Judge Hollis says.

Bankruptcy Judge Predicts Circuit Split on Substantive Consolidation with Nondebtors

The Seventh Circuit is likely to split with the Second, Sixth, Eighth, Ninth and Tenth Circuits by ruling that a debtor cannot be substantively consolidated with nondebtors, in the judgment of Chief Bankruptcy Judge Pamela S. Hollis of Chicago.

The chapter 7 trustee for a corporate debtor sued several non-bankrupt corporate affiliates, seeking substantive consolidation. In her May 3 opinion, Judge Hollis dismissed the complaint, concluding "that non-debtor substantive consolidation is not an available remedy in the Seventh Circuit."

Even if non-debtor substantive consolidation were available, Judge Hollis faulted the trustee for failing to give notice to all creditors of the nondebtor defendants.

Judge Hollis described substantive consolidation as a "judicially created remedy" that is "so extraordinary" because no provision in the Bankruptcy Code "provides for this relief."

She said the Seventh Circuit "has shown a distinct lack of enthusiasm for a bankruptcy court's use of [Section 105] and for creating rights based entirely on considerations of equity." As authority, she cited, among other cases, *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004), where the Seventh Circuit departed from other circuits by precluding chapter 11 debtors from obtaining so-called critical vendor orders.

On the other hand, she cited *In re Caesars Entertainment Operating Co.*, 808 F.3d 1186, 1188 (7th Cir. 2015), as endorsing "the exercise of a court's equitable powers when it serves one of the central objectives of the Bankruptcy Code." Although *Caesars* is the most recent authority, Judge Hollis called it "an outlier in the universe of Seventh Circuit precedent covering the use of equity in bankruptcy courts."

To bolster her conclusion, Judge Hollis said the trustee had other remedies, including an involuntary petition under the Bankruptcy Code or veil piercing under state law.

If presented with the issue, Judge Hollis therefore predicted that the Seventh Circuit would split with five other circuits and "not allow substantive consolidation of a bankruptcy debtor with entities that are not under the protection of the Bankruptcy Code."

Judge Hollis found another defect to warrant dismissal. Citing the Ninth Circuit Bankruptcy Appellate Panel, among other courts, she said the trustee must serve the substantive consolidation complaint on all creditors of the nonbankrupt defendants.

The opinion is *Audette v. Kasemir (In re Concepts America Inc.)*, 16-691 (Bankr. N.D. Ill. May 3, 2018).

Selling an Exempt Home

New York court delves into issues covered by the Fifth Circuit in **Hawk** *and* **DeBerry.**

A Pending Sale Contract Doesn't Obliterate a Homestead Exemption in Chapter 7

Signing a contract before bankruptcy to sell a home will not destroy a chapter 7 debtor's homestead exemption, according to Bankruptcy Judge Louis A. Scarcella of Central Islip, N.Y.

Before bankruptcy, the debtor signed a contract to sell her residence, which she claimed to be exempt under New York law. In that region of New York, the maximum homestead exemption was about $165,000 at the time. The debtor claimed a monetary exemption of about $125,000, representing the difference between her claimed value of the home and the encumbrances.

Were the house actually sold under the contract, the net proceeds would have been less than $150,000, still within the maximum New York homestead exemption.

The trustee objected to the exemption, contending that the state exemption did not apply because the debtor did not intend on living in the home indefinitely, as shown by the sale contract. The trustee also sought to be substituted as the seller so he could distribute the net proceeds to creditors.

As it turned out, the sale never closed. The debtor terminated the contract and returned the buyer's deposit. On several grounds, the trustee persisted in objecting to the exemption.

In his December 27 opinion, Judge Scarcella overruled the exemption.

The New York Exemption

Judge Scarcella said that exemptions are determined in chapter 7 as of the filing date, citing the so-called snapshot rule. Because the debtor lived nowhere else, owned the home, and still resided in the home on the filing date, he said she was entitled to the homestead exemption.

The trustee contended that New York law requires an intent to live in the home indefinitely. According to the trustee, the debtor was not entitled to the exemption because the contract showed she did not intend on continuing to reside in the home.

Judge Scarcella said that courts in New York squarely disagreed with the trustee and have held that state law requires no intent to reside in a home permanently. Intent to reside is only a question, he said, when the debtor owns more than one home.

Judge Scarcella said the trustee's argument was "reasonable but, in the end, unconvincing." He said that "bankruptcy courts in this circuit have been steadfast in holding that a debtor is entitled to the homestead exemption despite having entered into a prepetition contract of sale so long as the debtor owned and occupied the homestead on the petition date."

Judge Scarcella therefore held that the "existence of a prepetition contract of sale is immaterial if the debtor still owns and resides at her principal residence on the petition date."

The Fourteenth Amendment Argument

The trustee argued that New York law violated the Equal Protection Clause of the Fourteenth Amendment, because debtors in different circumstances are treated differently. Someone who sells a home can exempt about $165,000, while a debtor who does not own a home may exempt only about $5,500 in cash.

Although invited to participate, the New York Attorney General declined to submit a brief.

To establish a Fourteenth Amendment claim, Judge Scarcella said that the trustee "must prove that this alleged disparate treatment is without any rational basis." He proceeded to dismiss the constitutional argument, finding a "rational basis for any perceived difference in treatment" between someone who exempts the cash proceeds of a sale and a debtor who owns no home and only claims the minimal cash exemption.

The Voluntary Sale Argument

Because state law does not exempt proceeds from a voluntary sale outside of bankruptcy, the trustee contended the same result should apply when a debtor sells a home during bankruptcy.

Again, Judge Scarcella disagreed, because the argument ignores the snapshot rule. He also relied on Section 522(c).

Unless the case is dismissed, that section provides that exempt property "is not liable during or after the case" for any debt incurred before filing.

Judge Scarcella therefore overruled the objection to the debtor's homestead exemption.

The *Dicta*

In a statement that may be *dicta* at the end of the opinion, Judge Scarcella said that the debtor could exempt up to $165,000 in net proceeds if she were to sell the home voluntarily "during her bankruptcy case."

However, the amount of the exemption may not matter. After discharge, the debtor would only be liable for any debts that were excepted from discharge. Thus, she theoretically could retain proceeds in any amount if she had no surviving claims.

For the amount of the exemption to matter, the trustee must have objected to the homestead exemption and prove there was equity in the property above $165,000. Assuming the trustee did not challenge the amount of the exemption in a timely objection, the trustee presumably could not claim excess proceeds if the debtor were to sell her home after bankruptcy, even if the case were still pending.

Relevant authority on the issue is found in *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. 2017), where the Fifth Circuit held that an individual retirement account, exempt on the filing date, does not lose its exempt status even if it is converted to nonexempt property after the filing of a chapter 7 petition. Six months later, the Fifth Circuit expanded *Hawk* to protect proceeds of a homestead sold after a chapter 7 filing. *Lowe v. DeBerry (In re DeBerry)*, 884 F.3d 526 (5th Cir. March 7, 2018). For ABI's discussions of *Hawk* and *DeBerry*, click here and here.

The opinion is *In re Ward*, 16-72793 (Bankr. E.D.N.Y. Dec. 27, 2018).

Ninth Circuit opinion is prime for Supreme Court review regarding the extent of a bankruptcy court's contempt powers.

Ninth and Fourth Circuits Issue Important Rulings on Sanctions and Exemptions

The Ninth Circuit refused to rehear an appeal, setting up an opportunity for the Supreme Court to decide whether bankruptcy judges have constitutional power to impose sanctions as robust as Article III judges.

Meanwhile, the Fourth Circuit aligned itself with the Fifth by holding that events after a chapter 7 filing cannot undermine a homestead exemption.

In the Ninth Circuit case, a debtor defied a turnover order by refusing to cough up $1.4 million belonging to the estate. The bankruptcy judge imposed civil contempt sanctions of $1.4 million and $1,000 a day until the debtor complied.

The district court upheld the sanctions except for $1,000 a day, ruling that sanctions could not exceed the amount to be turned over.

In July 2017, the Ninth Circuit reversed and reinstated all of the sanctions imposed by the bankruptcy court. On May 8, the Ninth Circuit denied motions for rehearing and rehearing *en banc*, setting up the possibility of a petition for *certiorari* testing either constitutional limits on the severity of sanctions or the constitutional power of bankruptcy courts to impose sanctions far surpassing the amount in controversy.

To read ABI's discussion of the July 2017 opinion by the Ninth Circuit, click here.

In a significant case involving the homestead exemption for chapter 7 debtors, the Fourth Circuit gave the highest compliment to District Judge James K. Bredar of Baltimore by affirming his decision for the reasons stated in his opinion from August 2017.

A husband owned a home with his wife as tenants by the entireties. The wife did not file. After filing, the wife died, prompting the chapter 7 trustee to argue that the home was no longer entireties property exempted under Section 522(b)(3)(B).

The bankruptcy court overruled the trustee's objection and was upheld by Judge Bredar.

ROCHELLE'S DAILY WIRE

Following Fourth Circuit authority, *Birney v. Smith (In re Birney)*, 200 F.3d 225 (4th Cir. 1999), Judge Bredar said that the entireties exemption did lapse on the wife's death, but, as *Birney* said, that "does not end the inquiry."

There still must be a provision in the Bankruptcy Code bringing the property into the estate.

Unlike chapters 11, 12 and 13, there is no provision in chapter 7 bringing after-acquired property into the estate. Therefore, Judge Bredar held that the home was not brought into the estate.

By upholding Judge Bredar, the Fourth Circuit has firmly aligned itself with the Fifth Circuit, which held in *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017), that exempt property on the filing date does not lose its exempt status even if it is converted to nonexempt property after the filing of a chapter 7 petition.

The Fifth Circuit expanded *Hawk* six months later by holding that a chapter 7 debtor did not lose the exemption in his home even though he sold the property after filing and did not reinvest the proceeds in another home within the six-month window allowed by Texas law. *Lowe v. DeBerry (In re DeBerry)*, 884 F.3d 526 (5th Cir. March 7, 2018). For ABI's discussion of *Hawk* and *DeBerry*, click here and here.

We submit that the Fourth Circuit's ruling and the opinions in *Hawk* and *DeBerry* are little more than a reaffirmation of the so-called snapshot test. Those opinions were necessitated by creative arguments designed to undermine the snapshot rule.

The rulings by the Ninth and Fourth Circuits are *Gharib v. Casey (In re Kenny G. Enterprises LLC)*, 16-55007 (9th Cir. May 8, 2018), and *Bellinger v. Buckley*, 17-2138 (4th Cir. May 9, 2018).

Earned Income Tax Credit

On direct appeal, Seventh Circuit upholds Bankruptcy Judge Thorne by allowing chapter 13 debtors to retain anticipated refunds from earned income tax credits.

Seventh Circuit Allows Anticipated Tax Refunds to Be Offset by Expenses in Chapter 13

Affirming Bankruptcy Judge Deborah L. Thorne on direct appeal, the Seventh Circuit held that a chapter 13 debtor can prorate an earned income tax credit in calculating disposable income and may offset the tax refund income with "reasonably necessary expenses to be incurred throughout the year."

The appeals court rejected the chapter 13 trustee's argument that the tax credit should be turned over in full to allow an extra payment to creditors, without deduction for any expenses.

The Poverty Level Debtor's $4,000 Tax Credit

A single mother of three children, the below-median income debtor had an annual income of about $30,000, well below the median income threshold of $87,000 in Chicago. Calculating projected monthly income, the debtor included a proration for her anticipated earned income tax credit of about $4,000 a year.

After several amendments to her schedules, the debtor proposed a 48-month plan paying her creditors $74 a month, an amount equal to her calculation of monthly disposable income. Creditors would receive a total of about $6,000. In other words, the plan would have paid creditors three or four times more were the tax refunds earmarked in full for creditors, without deduction.

In calculating disposable income, the debtor in substance included several one-time expenses that she could not incur or pay without using the earned income tax credit, such as buying beds for her sons, who were sleeping on air mattresses. The appeals court said that the additional expenses allowed the debtor to "retain some, or even all, of her tax credits."

Even with the extra income from the tax refund and the additional expenses, Judge Thorne found that the debtor had "a pretty skinny budget overall."

The chapter 13 trustee objected to confirmation, arguing that the debtor should turn over the entire amount of the earned income tax refund when received to fund additional payments to creditors.

Consolidating three chapter 13 cases raising identical issues, Judge Thorne overruled the objections and confirmed the debtors' plans in March 2017. Judge Thorne later certified an issue for direct appeal. The Seventh Circuit agreed to hear the direct appeal, saying there was no authority from the Supreme Court or the Seventh Circuit saying whether tax credits are disposable income.

Interestingly, the trustee and the debtor agreed that tax credits are disposable income. Prompting a dissent from one judge on the panel, the appeals court nonetheless went on to decide the next question: Can a debtor prorate tax credits to be offset by anticipated expenses?

The Seventh Circuit Opinion

In his March 22 opinion, Circuit Judge Joel M. Flaum agreed with the parties and held that tax credits are included in "currently monthly income," as defined in Section 101(10A)(A) and referred to in Section 1325(b)(1).

Nonetheless, Judge Flaum said that including tax credits within currently monthly income "does not mean that the debtor must pay the entire tax credit to the trustee as disposable income."

To retain some or all of the tax refunds, the trustee argued that the debtor must file a motion to amend the plan every time a refund comes in. Judge Flaum said that Judge Thorne rejected that idea "to alleviate the burdens that the motion-to-modify process imposes on trustees, debtors, and the court."

Judge Flaum likewise rejected the argument, relying on *Hamilton v. Lanning*, 560 U.S. 505 (2010), where the Supreme Court adopted a "forward-looking approach" and said that "the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation."

Judge Flaum said that Judge Thorne "properly allowed *Lanning* to calculate [the debtor's] projected disposable income," because her receipt of the tax credit refund was "virtually certain."

On the other hand, Judge Flaum said, the trustee's argument "is just another version of the rigid mechanical approach the Supreme Court rejected in *Lanning*." In contrast, Judge Thorne's approach of offsetting expenses against anticipated tax refunds "is exactly the kind of forward-looking approach that the Supreme Court endorsed in *Lanning*."

In a two-page opinion, Circuit Judge Daniel A. Manion concurred in part and concurred in the judgment, but not in a fashion undercutting the holding regarding the treatment of expenses to offset tax refunds.

Judge Manion said the circuit should not have accepted the case because the trustee and the debtor agreed on the issue that Judge Thorne certified for direct appeal. However, he concurred with the remainder of the opinion, holding "that the bankruptcy court did not abuse its discretion in overruling the trustee's objections to the debtor's chapter 13 plan." He would have expressed no opinion "on whether the earned income tax credit qualifies as income under the Bankruptcy Code" because there was "no adverse briefing on the issue and the resolution would not affect the outcome."

The opinion is *Marshall v. Blake*, 17-2809 (7th Cir. March 22, 2018).