Money-Back Guarantee?

Chrisandrea L. Turner, Moderator
Stites & Harbison, PLLC; Lexington, Ky.

Hon. Jennifer H. Henderson
U.S. Bankruptcy Court (N.D. Ala.); Tuscaloosa

Charles N. Kelley, Jr.
Cummings & Kelley P.C.; Gainesville, Ga.

Ryan J. Williams
Staff Attorney for Nancy J. Whaley, Chapter 13 Trustee; Atlanta

JUDICIAL ESTOPPEL THROUGHOUT THE CIRCUITS

"The doctrine of judicial estoppel prevents a party from asserting a claim in a legal proceeding that is inconsistent with a claim taken by that party in a previous proceeding," *New Hampshire v. Maine*, 532 U.S. 742, 121 S. Ct. 1808 (2001) citing 18 Moore's Federal Practice § 134.30, p. 134-62 (3d ed. 2000).

I. Determining whether the application of judicial estoppel is proper

A. SCOTUS

"The circumstances under which judicial estoppel may appropriately be invoked are probably not reducible to any general formulation of principle," *New Hampshire v. Maine*, 532 U.S. 742, 121 S. Ct. 1808 (2001).

In the *New Hampshire* decision, the Court outlined numerous factors for determining whether to apply the doctrine to a particular case[1]:

1. A party's later position must be "clearly inconsistent" with its earlier position;
2. whether the party has succeeded in persuading a court to accept that party's earlier position, so that judicial acceptance of an inconsistent position in a later proceeding would create "the perception that either the first or the second court was misled; and
3. whether the party seeking to assert an inconsistent position would derive an unfair advantage or impose an unfair detriment on the opposing party if not estopped.

The Court would state later in its decision that "it may be appropriate to resist application of judicial estoppel when a party's prior position was based on *inadvertence or mistake*."[2]

B. Eleventh Circuit

The Eleventh Circuit has incorporated the standards outlined in the *New Hampshire* decision into two factors for establishing the bar of judicial estoppel.

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[1] *Id.* at 750-751.
[2] *Id. at 753.*

1. "First, it must be shown that the allegedly inconsistent positions were made under oath in a prior proceeding."
2. "Second, such inconsistencies must be shown to have been calculated to make a mockery of the judicial system."

Robinson v. Tyson Foods, Inc., 595 F.3d 1269, 1273 (11th Cir. 2010) (quoting *Burnes v. Pemco Aeroplex*, Inc., 291 F.3d 1282, 1285 (11th Cir. 2002)). Similarly to the opinion in *New Hampshire,* the 11th Circuit in *Burnes* did recognize that these factors are not exhaustive and court must always give due consideration to the circumstances of the particular case.

C. General Principle

Most Circuits have similarly incorporated the factors outlined in *New Hampshire* to create standards for determining the application of judicial estoppel, and most are seeking a finding that:

1. a party's position in a case or controversy which is plainly inconsistent with a prior position
2. a court accepted the prior position; and
3. the party intentionally mislead the court and did not act **inadvertently**.

II. How does one define "inadvertence"?

Burnes has been considered the seminal case in the 11th Circuit[3], and *Burnes* relies upon *Barger v. City of Cartersville*, 348 F.3d 1289 (11 Cir. 2003) in which a special meaning for the term "inadvertence" was created in the context of judicial estoppel. The need for drafting a special meaning for "inadvertence" was based on the understanding that Debtors would commonly claim inadvertence and would heavily rely on a "convenient ignorance of the duty to disclose." *Brothers v. Bojangles' Rests., Inc.,* No. CV-12-BE-2212-E, 2013 U.S. Dist. LEXIS 165336 (N.D. Ala. Nov. 21, 2013).

"Indeed, if debtors could always successfully hide behind such a subjective assertion, unscrupulous debtors with both civil and bankruptcy suits pending might well make tactical

[3] As stated in *Robinson v. Tyson Foods, Inc.*, 595 F.3d 1269 at 1274 (11th Cir. 2010)

decisions not to disclose their civil claims and hope that a discharge occurs before the civil claims come to light, with no true penalty for their misconduct," *Id.*

The Court would come to define a Debtor's failure to disclose as "inadvertent" in this context when "...the Debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment." *Barger* at 1295-96.

III. "Motive for Concealment"

There have been numerous decisions based on the finding that the Debtor acted with a motive for concealment. The standard has been applied very broadly and consistently against the Debtor because the Debtor almost always has a motive for concealment by the fact that they are seeking a judgment in their favor that will result in a monetary gain for them.

A. Cases where a motive of concealment was found:

Robinson v. Tyson Foods, Inc., 595 F.3d 1269 at 1275-76: The district court's reasoning was not clearly erroneous when it found the debtor had a motive to conceal because if she realized any funds, she would have been able to keep the proceeds for herself. The Debtor argued that because her plan proposed full repayment of creditors she had no motive to conceal. The court denied that argument on the basis that "the motive to conceal stems from the possibility of defrauding the courts and not from any actual fraudulent result." *Id.* at 1275. The Debtor did ultimately end up paying her creditors in full and argued she should not be penalized for a speculative recovery. The court denied this argument as well because the Debtor "ha[d] the benefit of making this argument in hindsight. When reviewing potential motive, the relevant inquiry is intent at the time of non-disclosure." *Id.* at 1276

Barger v. City of Cartersville, 348 F.3d 1289, 1296 (11th Cir. 2003): Barger appeared to gain an advantage when she failed to list her discrimination claims on her schedule of assets. Omitting the discrimination claims from the schedule of assets appeared to benefit her because, by omitting the claims, she could keep any proceeds for herself and not have them become part of the bankruptcy estate. Thus, Barger's knowledge of her discrimination claims and motive to conceal them are sufficient evidence from which to infer her intentional manipulation.

De Leon v. Comcar Indus., 321 F.3d 1289, 1292: De Leon certainly knew about his claim and possessed a motive to conceal it because his amount of repayment would be less, we can infer from the record his intent "to make a mockery of the judicial system."

IV. Examples of the application of Judicial Estoppel throughout the Circuits

A. Second Circuit - Coffaro v. Crespo, 721 F. Supp.2d 141, 145 (E.D.N.Y. 2010).

Debtor filed for bankruptcy. Coffaro filed a complaint against the Debtor seeking a determination that he was the rightful owner of a Salvador Dali art piece. Debtor did not list the painting or a claim to it as one of his assets and claimed the failure to disclose was a mistake since he did not believe it was recoverable as a third party had possession of it. The court held that Debtor's failure to list the painting was not a mistake. He simply chose not to list his claim because he believed that recovery was unlikely or too expensive. His belief that the painting was unrecoverable was not sufficient for failing to list the claim in his schedules. Even if he believed the painting was unrecoverable, he had a legal obligation to list it as an asset or to at least list a claim for damages. The court further held that Crespo had a motive to conceal his alleged interest in the painting. Knowledge of the possible claim, no matter how unlikely the recovery, judicially estops Crespo from asserting ownership in the painting.

B. Fourth Circuit - Evans v. Allied Air Enterprises, 2011 U.S. Dist. LEXIS 112212 (D.S.C. Sept. 30, 2011).

Debtor filed an EEOC cause of action against his former employer on a basis of discrimination, and shortly thereafter filed a Chapter 7 bankruptcy through counsel. Debtor contended he had informed his counsel and was advised that the claim was not property of the estate. After discharge, the Debtor reopened his case to disclose the claim. The court held that judicial estoppel was property as to the Debtor but the Trustee was not estopped from pursuing the claim for the betterment of creditors of the estate.

C. Fifth Circuit - Richards v. Wal-Mart Stores, Inc., 2012 U.S. Dist. LEXIS 170583 (W.D. La. Nov. 30, 2012).

Approximately one year after the Debtor-wfe filed a Chapter 13 bankruptcy, she suffered injury when a juice box display fell upon her and she ultimately pursued a cause of action against Wal-mart. Wal-mart filed a motion for summary judgment on the premise of judicial estoppel for the Debtor's failure to disclose the claim in her pending bankruptcy. The Debtor contended that their failure to disclose the lawsuit was inadvertent because she nor their attorney knew that disclosure was required and because the bankruptcy trustee informed them that the cause of action would not be included in the bankruptcy plan. The court held that their reliance on the trustee's assertions was not reasonable and that the Debtor had a motive to conceal. Motive to conceal is almost always met when a debtor fails to disclose a claim or possible claim to the bankruptcy court. The court did ultimately decide though to not invoke judicial estoppel as a matter of equity after consideration of all the facts.

D. Sixth Circuit - Garret v. Univ. Hosp. of Cleveland, Inc., 2013 U.S. Dist. LEXIS 71758 (N.D. Ohio May 21, 2013).

Debtor filed bankruptcy five months after commencing action against her former employer related to her termination. Debtor argued the failure to disclose was inadvertent and would only result in a windfall to the Hospital. The court granted University Hospital's motion for judgment on the pleadings since the Debtor did not disclose the claim except in response to University Hospital's motion for judgment on the pleadings. The court noted that assertions of lack of sophistication and legal ignorance are unreasonable to demonstrate inadvertence since the Debtor was represented. To allow a party to amend bankruptcy schedules only after an omission is raised encourages debtors to disclose some assets only if they are caught concealing them.

E. Seventh Circuit - David v. Wal-Mart Stores, Inc., 2014 U.S. Dist. LEXIS 151241 (N.D. Ill. Oct. 24, 2014).

Debtor filed a pro se Chapter 7 bankruptcy approximately one month after filing an EEOC claim against his former employer for wrongful termination. Debtor argued that judicial estoppel should not apply because the failure to disclose was inadvertent. Wal-Mart contended that the alleged innocence of David's failure to disclose has no legal significance because even

an inadvertent failure to disclose results in judicial estoppel. The court held judicial estoppel only applies if the failure to disclose resulted from an intent to deceive or manipulate the bankruptcy court. Judicial estoppel is a doctrine intended to prevent the perversion of the judicial process.

F. Eighth Circuit - EEOC v. CRST Van Expedited, Inc., 614 F. Supp.2d 968 (N.D. Iowa 2009).

Three difference women had filed bankruptcy after alleged sexual harassment had occurred while employed with a common employer. All three had failed to schedule any potential claim. All three women relied on inadvertence as the reason for failing to disclose the claim. The court held that the judicial estoppel doctrine clearly applied to all three women since all three represented to court that they did not have a claim; persuaded the court to rely upon that false assertion; and would gain an unfair advantage with any other ruling. The debtors' failure to disclose is inadvertent only when, in general, the debtor either lacks knowledge of the undisclosed claim or has not motive for their concealment.

G. Ninth Circuit - Ah Quin v. County of Kauai DOT, 733 F.3d 267, 272 (9th Cir. Haw. 2013).

Debtor commenced an employment discrimination action against the County DOT and within the year filed for bankruptcy. She failed to list the employment discrimination action in her bankruptcy schedules and further testified that she had listed all of her assets. An order of discharge was entered and the case was closed. The County DOT notified the district court that it could move to dismiss the action under the doctrine of judicial estoppel. As a result, Debtor moved to reopen her case and set aside the discharge order. She contended that her failure to list the asset was due to a misunderstanding of what she was required to do. The bankruptcy case was reopened and the schedules were amended to disclose the asset. The Trustee filed a notice of abandonment and the case was re-closed. The district court held that judicial estoppel prohibited the Debtor from proceeding and granted summary judgment to the County DOT. The Circuit Court held that the district court applied the wrong legal standard for a determination as to whether the omission was "mistaken" or "inadvertent". The court held that although the debtor initially took inconsistent positions, the bankruptcy court ultimately did not accept the initial position. The application of judicial estoppel operates to the detriment primarily of innocent creditors and to the benefit only of an alleged bad actor. The court found that there was factual

evidence to support either mistake or inadvertence or of deceit and that the district court's interpretation of inadvertence and mistake was too narrow.

H. Tenth Circuit - Cole v. Convergys Customer Mgmt. Group, 2013 U.S. Dist. LEXIS 69466 (D. Kan. May 16, 2013).

The Debtor filed a discrimination action with EEOC and later filed a Chapter 7 bankruptcy. Debtor stated in her schedules that she had no contingent or unliquidated claims. The court found that Cole's assertions of her claims is clearly inconsistent with the position she took in her bankruptcy filings, they worked to mislead the court to accept her position, and thus received an unfair advantage when she received a discharge without disclosing any actual or potential claims. Cole failed to show any reason why she did not include the discrimination claims and her state law claims in her bankruptcy schedules. The Court found that her obligation to disclose is an ongoing one. She had knowledge of the undisclosed claims and had a motive for their concealment.

I. Eleventh Circuit - Brothers v. Bojangles' Rests., Inc., 2013 U.S. Dist. LEXIS 165336 (N.D. Ala. Nov. 21, 2013).

Debtor filed a Chapter 13 bankruptcy on June 7, 2011, within a year of becoming employed at Bojangles. The plan was confirmed on September 9, 2011 and on October 8, 2011 Debtor was terminated. Within her charge to the EEOC she indicated that she was exposed to sexual harassment and racial discrimination during her employment with Bojangles. Later a complaint was filed against Bojangles, yet no amendment to the schedules to disclose the lawsuit occurred.

The court held that Brothers had a continuing duty to disclose assets in her bankruptcy case and her failure to amend her bankruptcy documents means that she took inconsistent positions under oath. The Debtor attempted to argue that the failure to disclose was inadvertent and that no harm occurred by the fact that she amended to disclose before entry of discharge and therefore judicial estoppel should not be applied, but cited no authority on the issue. The court held that a debtor's failure to satisfy her statutory disclosure obligations is "inadvertent" only when the debtor either lacks knowledge of the undisclosed claims or has no motive for their concealment. The court ruled that judicial estoppel applied and the Debtor was precluded from pursuing her actions against Bojangles.

Retention of Claims in Individual Chapter 11 Cases

It has long been settled that an individual—including individuals not engaged in business—may file a Chapter 11 case.[1] In *Toibb v. Radloff*, the Supreme Court considered the question of whether an individual not engaged in business could be a debtor under Chapter 11. In reaching its conclusion that they could it made short work of any question of an individual's ability to file a Chapter 11.[2] The Court simply looked to the language of Section 109(d) of the Bankruptcy Code and determined from the plain language of that statute that an individual was permitted to file Chapter 11.[3]

Chapter 11 has a myriad of requirements beyond those contained in Chapter 13. There are additional requirements for the contents of a plan[4], obligations to prepare and obtain approval of a disclosure statement[5], and the right of creditors with impaired claim to vote on acceptance of the proposed plan[6], among others.

While consumer practitioners are probably aware of these requirements, one area that can be overlooked is disclosure and treatment of claims belonging to the bankruptcy estate under 11 U.S.C. § 1123(b)(3). That subsection provides that a Chapter 11 plan may

> provide for—
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> (A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or

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[1] *Toibb v. Radloff*, 501 U.S. 157 (1991).

[2] *Id.* at 160-61.

[3] The Court also made short work of the Circuit Court's reasoning prohibiting a debtor not engaged in business from filing a Chapter 11 case. In the Court's view it was not possible to graft an "engaged in business" requirement on to the requirements for being a Chapter 11 debtor from the legislative history of the Bankruptcy Code because the language of Section 109(d) was clear and unambiguous. *Id.* at 162.

[4] 11 U.S.C. § 1123.

[5] 11 U.S.C. § 1125.

[6] 11 U.S.C. §§ 1126, 1129(a)(8).

> (B) the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest.[7]

Section 541 of the Bankruptcy Code creates upon the filing of a case a bankruptcy estate, which is "comprised of" all of the assets of the debtor that existed on the date the case was filed plus the estate's interest in avoidance actions and their proceeds.[8] While the debtor, acting as a debtor in possession, can prosecute those actions prior to the confirmation of a Chapter 11 plan,[9] confirmation of a plan eliminates the bankruptcy estate and thus the debtor in possession's authority.[10] Because the terms of a confirmed Chapter 11 plan bind all parties to the case in the same manner as a district court judgment[11] courts have generally held that any causes of action not addressed in the Chapter 11 are lost.[12]

Section 1123(b)(3) allows a Chapter 11 debtor (or other plan proponent) to preserve a cause of action for prosecution by the reorganized debtor or another representative of the estate. It does not, however, set forth the manner of preserving the causes of action. Specifically, Section 1123(b)(3) does not provide what level of specificity is required for preserving a cause of action.

Not surprisingly, the courts have split on the proper way to comply with the provisions of Section 1123(b)(3). The case law has developed essentially three different approachs to

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[7] 11 U.S.C. § 1123(b)(3). There is no analogous provision in Chapter 13. *Compare* 11 U.S.C. § 1322

[8] 11 U.S.C. § 541(a)(3), (4), and (7); *United States v. Whiting Pools*, 462 U.S. 198 (1983); *Compton v. Anderson (In re MPF Holdings US LLC)*, 701 F.3d 449, 453 (5th Cir. 2012); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991).

[9] *Dynasty Oil and Gas, LLC v. Citizens Bank (In re United Operating, LLC)*, 540 F.3D 351, 355; 11 U.S.C. § 323(b).

[10] *Binder v. Price Waterhouse & Co., LLP (In re Resorts Int'l, Inc.)*, 372 F.3d 154, 165 (3d Cir. 2004); *Fairfield Communities v. Daleske (In re Fairfield Communities)*, 142 F.3d 1093, 1095 (8th Cir. 1998).

[11] *First Union Commer. Corp. v. Nelson, Mullins, Riley, & Scarborough (In re Varat Enters.)*, 81 F.3d 1310 (4th Cir. 1996).

[12] *See, e.g., Sure-Snap Corp. v. State Street Bank & Trust Co.*, 948 F.2d 869 (2d Cir. 1991).

complying with Section 1123(b)(3).[13] One approach holds to the idea that a simple disclosure of the categories or types of claims is sufficient to preserve them. The second approach is essentially a totality of the circumstances test—varying the specificity required based on the facts and circumstances of the individual case. The third approach, however, requires far more specificity, even going so far as to require a "specific and unequivocal" reservation of the cause of action for it to survive post-confirmation.[14]

The First and Seventh Circuits have both concluded that a reservation of a class or category of claim is sufficient.[15] They reason that the language of the statute does not require the reservation of a cause of action to be specific and that plan or disclosure statement language that provides for reservation of a clearly described category of claims is sufficient for purposes of reserving the cause of action post-confirmation.[16]

The Fifth, Sixth, and Eighth Circuits require significantly more specificity for a plan to preserve a cause of action after confirmation. For both the Sixth and Eighth Circuits the plan must identify the cause of action and the defendant to preserve the right to sue post-confirmation.[17] The Fifth Circuit, on the other hand, requires a plan to identify the legal basis for the suit.[18]

The Fifth Circuit's decision in *In re MPF Holdings* is instructive. There the plan provided that certain claims were preserved and assigned to a litigation trustee. The claims preserved and assigned were described as "any and all actual or potential claims or Causes of Action to avoid a transfer of property or an obligation incurred by the Debtors pursuant to any applicable section of the Bankruptcy Code, including §§ 542, 543, 544, 545, 547, 548, 549, 550, 551, 553,

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[13] *Futter v. Duffy (In re Futter Lumber Corp.)*, 473 B.R. 20, 30 (E.D.N.Y. 2012)

[14] *In re United Operating, LLC*, 540 F.3d at 355.

[15] *Fleet Nat'l Bank v. Gray (In re Bankvest Capital Corp.)*, 375 F.3d 51, 59 (1st Cir. 2004); *P.A. Bergner & Co. v. Bank One, N.A. (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1117 (7th Cir. 1998).

[16] *Id.*

[17] *Browning v. Levy*, 283 F.3d 761 (6th Cir. 2002); *Harstad v. First Am. Bank*, 39 F.3d 898 (8th Cir. 1994)

[18] *In re MPF Holdings US LLC*, 701 F.3d at 455.

and 542(a)."[19] When the litigation trustee brought a series of avoidance actions the bankruptcy court dismissed them, finding that the preservation language quoted above was insufficient.[20]

The Fifth Circuit Court of Appeals determined that the language set forth was sufficient.[21] Based upon the court's prior ruling in *Spicer v. Laguna Madre Oil & Gas II, LLC (In re Texas Wyoming Drilling Inc.)*[22] it concluded that the bankruptcy court had required too much specificity by requiring the naming of defendants who would be sued. For the Fifth Circuit it is sufficient that the causes of action be identified.

The take away out of all of this for a practitioner representing an individual debtor with a potential claim against a third party in a Chapter 11 case is, ultimately, disclosure. In commercial contexts there is frequently a tension between the claims retained and the creditors that will be voting on the plan. It is not unusual for a debtor to hold a claim for a preference against a creditor who also has the right to vote on the plan. Making it plain that the claim survives could easily give that creditor motivation to oppose the plan.

For individuals, however, the bulk of the claims are not against creditors. They are generally speaking tort or contract claims against third parties who do not hold a claim back against the debtor. There is accordingly less risk for the debtor in disclosing such a claim specifically. In such a case it would be prudent to describe—to the extent possible—the nature of the claim and the known defendants so that there is less risk that the claim will be dismissed at a later point as barred by confirmation of the Chapter 11 plan.

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[19] *Id.* at 452.

[20] *Id.* at 452-53.

[21] *Id.* at 456.

[22] 647 F.3d 547 (5th Cir. 2011).

Unanswered Questions Post-*Harris* and the Bankruptcy Courts' Response[1]

I. Introduction

In *Harris v. Viegelahn*,[2] the Supreme Court held that upon post-confirmation conversion of a chapter 13 case to a case under chapter 7 of the Bankruptcy Code[3] the chapter 13 trustee must return all monies on hand to the debtor.[4] In so holding the Court reversed a decision of the Fifth Circuit Court of Appeals and resolved a circuit split.[5] The *Harris* Court reasoned that allowing a chapter 13 trustee to disburse a debtor's post-petition wages[6] to creditors after conversion of the debtor's case to chapter 7 was incompatible with Bankruptcy Code sections 348(f)(1)(A)[7] and 348(e).[8] The Court rejected the trustee's arguments that Bankruptcy Code sections 1327(a)[9] and 1326(a)(2) [10] required the trustee to distribute the accumulated funds to creditors.[11] The Court explained, "When a debtor exercises his statutory right to convert, the case is placed under [c]hapter 7 governance, and no [c]hapter 13 provision holds sway."[12] The Court also pointed out that, under Rule 1019 of the Federal Rules of Bankruptcy Procedure, distributing funds to creditors is not among the post-conversion duties of a terminated chapter 13 trustee.[13]

The *Harris* decision left unanswered several questions. What happens to accumulated funds when a chapter 13 case is converted pre-confirmation? What happens to such funds when a chapter 13 case is dismissed? This paper discusses how courts have answered these questions and

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[1] Contributing Authors: Traci Cunningham, University of Alabama School of Law student (Class of 2018) and 2016 summer intern to Jennifer H. Henderson, United States Bankruptcy Judge, Northern District of Alabama, Western Division; Joshua Johnson, Career Law Clerk to Judge Jennifer Henderson; and Judge Jennifer Henderson.

[2] 135 S.Ct. 1829 (2015).

[3] As used herein, "Bankruptcy Code" refers to title 11 of the United States Code, 11 U.S.C. §§ 101-1532.

[4] 135 S.Ct. at 1837.

[5] *Id.* at 1836; *see also In re Harris*, 757 F.3d 468 (5th Cir. 2014) (holding that the chapter 13 trustee could disburse funds in accordance with the debtor's confirmed chapter 13 plan following conversion to chapter 7); *In re Michael*, 699 F.3d 305 (2012) (holding that all funds should be returned to debtor upon conversion from chapter 13 to chapter 7).

[6] In *Harris* the subject funds were comprised of plan payments withheld from the debtor's post-petition wages. 135 S.Ct. at 1836.

[7] Section 348(f)(1)(A) provides that "when a case under chapter 13...is converted...property of the estate in the converted case shall consist of property of the estate, *as of the date of filing of the petition*, that remains in the possession of or is under the control of the debtor on the date of conversion." 11 U.S.C. § 348(f)(1)(A) (emphasis added).

[8] Section 348(e) states that "conversion of a case under section...1307 of this title terminates the service of any trustee...that is serving in the case before such conversion." *Id.* at § 348(e); *see also* 135 S.Ct. at 1837-1838.

[9] Section 1327(a) provides that a confirmed chapter 13 plan "bind[s] the debtor and each creditor." 11 U.S.C. § 1327(a).

[10] Section 1326(a)(2) provides that, if a plan is confirmed, the trustee shall distribute plan payments made pursuant to section 1326(a)(1) "in accordance with the plan." 11 U.S.C. § 1326(a)(2).

[11] 135 S.Ct. at 1838.

[12] *Id.*

[13] *Id.* at 1839 (noting that the chapter 13 trustee's post-conversion duties are to (1) turn over records and assets to the chapter 7 trustee, pursuant to Rule 1019(4), and (2) to file a report with the United States trustee, pursuant to Rule 1019(5)(B)(ii)).

highlights some changes to local bankruptcy rules, procedures, and forms brought about by the *Harris* decision.

II. Does *Harris* Control in the Case of Pre-Confirmation Conversion from Chapter 13 to Chapter 7?

A. Majority view

A majority of courts have held that *Harris* requires the distribution of accumulated funds to the debtor when the debtor's chapter 13 case is converted to a case under chapter 7 pre-confirmation.[14] These courts have determined that *Harris's* conclusion that "no Chapter 13 provision holds sway" post-conversion applies equally in the case of pre-confirmation conversion from chapter 13 to chapter 7.[15]

B. Minority view

At least one court has held that *Harris* does not preclude the payment of allowed administrative claims after the debtor converts a chapter 13 case, pre-confirmation, to a case under chapter 7.[16] In *In re Brandon*, the bankruptcy court distinguished *Harris* on the grounds that *Harris* addressed a post-confirmation conversion, which is only one of the procedural scenarios addressed in section 1326(a)(2).[17] The court reasoned that the three sentences comprising Bankruptcy Code section 1326(a)(2) each apply to different situations based on the procedural posture of the case.[18] Noting that the Court in *Harris* only considered the second sentence of 1326(a)(2)—which provides that, "if a plan is confirmed, the trustee shall disburse any [payment made under section 1326(a)(1)] "in accordance with the plan as soon as is practicable"—not the third sentence of

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[14] *In re Hoggarth*, 546 B.R. 875, 878 (Bankr. D. Colo. 2016) (Judge Brown) (declining to decide the case on section 1326(a)(2) and instead deciding the case on the broad language from *Harris* that "no Chapter 13 provision holds sway" post-conversion); *In re Vonkreuter*, 545 B.R. 297, 303 (Bankr. D. Colo. 2016) (Chief Judge Romero) (finding that *Harris* applies equally to pre-confirmation conversions and declining to find that administrative claims under section 503(b) may be paid from post-petition earnings upon conversion of the case); *In re Marshall*, No. 15–10350, 2016 WL 402386 at *1 (Bankr. W.D. La. Jan. 28, 2016) (Judge Norman) (holding that all funds held by a chapter 13 trustee at the time of conversion must be returned to the debtor pursuant to *Harris*); *In re Beckman*, 536 B.R. 446, 448 (Bankr. S.D. Cal 2015) (Judge De Carl Adler) (joining other courts who have found that the Supreme Court analysis in *Harris* is equally applicable to a situation where no plan has been confirmed); *In re Spraggins*, No. 13–28807–ABA, No. 14–29130–ABA, No. 14–35351–ABA, 2015 WL 5227836 at *3 (Bankr. D.N.J. Sept. 4, 2015) (Judge Altenburg, Jr.) (holding that a debtor is entitled to a refund of all post-petition wages on conversion from chapter 13 to chapter 7 absent bad faith); *In re Sowell*, 535 B.R. 824, 827 Bankr. D. Minn. 2015) (Judge Ridgeway) (finding that *Harris* applies in a no-look fee situation); *In re Beauregard*, 533 B.R. 826, 832 (Bankr. D.N.M. 2015) (Judge Jacobvitz and Judge Thuma) ("In sum, the *Harris* decision means that if a [c]hapter 13 case is converted to [c]hapter 7 before plan confirmation, all funds held by the standing [c]hapter 13 trustee on conversion that are not property of the [c]hapter 7 estate must be returned to the debtor, without paying administrative expenses."); *In re Ulmer*, No. 15-30220, 2015 WL 3955258 at *2 (Bankr. W.D. La. June 26, 2015) (Judge Hunter) (finding that "the trustee must comply with [*Harris*] if a case is converted" pre-confirmation).

[15] *See, e.g.*, *In re Hoggarth*, 546 B.R. at 878; *In re Beckman*, 536 B.R. at 449.

[16] *See In re Brandon*, 537 B.R. 231, 236 (Bankr. D. Md. 2015) (Judge Rice).

[17] *Id.*

[18] *Id.* at 237.

section 1362(a)(2)—which provides that "[i]f a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b)" —the court in *Brandon* declined to extend the ruling in *Harris* to pre-confirmation conversion.[19] Pointing out that the *Harris* Court sided in favor of the Third Circuit in resolving the circuit split, the *Brandon* court relied on dicta from the leading Third Circuit decision to hold that, in the case of pre-confirmation conversion, a trustee is required by section 1326(a)(2) to pay allowed administrative expense claims from accumulated funds prior to returning plan payments to the debtor.[20]

III. Does *Harris* Apply When a Chapter 13 Case is Dismissed?

Most courts have not applied *Harris* in the context of dismissal.[21] Among other things, *Harris* considered Bankruptcy Code section 348, which speaks to the effect of conversion,[22] not Bankruptcy code section 349, which governs the effect of dismissal.[23] Significantly, service of a chapter 13 trustee does not terminate on dismissal under section 349.[24] Also, the Court in *Harris* relied on Bankruptcy Code section 103(i)—which states that chapter 13 of title 11 applies only in a case under such chapter—to hold the provisions of chapter 13 inapplicable to a converted case.[25] As one court explained, certain provisions of chapter 13 "statutorily and necessarily apply in a chapter 13 case that has been dismissed but not yet closed."[26]

Although courts largely have agreed that *Harris* does not apply when a chapter 13 case is dismissed, courts tasked with considering the appropriate disposition of accumulated funds on

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[19] *Id.*
[20] *Id.* (citing *In re Michael*, 699, F.3d 305, 310 (3d Cir. 2012).
[21] *In re Wheaton*, 547 B.R. 490, 499 (B.A.P. 1st Cir. 2016) (Judge Boroff) (holding that undistributed plan payments could be used to pay debtor's counsel in the event of a pre-confirmation dismissal); *In re Merovich*, 547 B.R. 643, 647 (Bankr. M.D. Pa. 2016) (Judge Opel, II) (holding that *Harris* was not controlling in the context of a pre-confirmation dismissal); *In re Cohen*, No. 2:14–bk–11079–DPC, 2016 WL 797656 *4-5 (Bankr. D. Ariz. Feb. 29, 2016) (Chief Judge Collins) (finding that *Harris* did not apply to a dismissal and holding that a levy could attach to funds in the trustee's possession); *Matter of Hightower*, No. 14–30452–EJC, 2015 WL 5766676 at *5 (Bankr. S.D. Ga. Sept. 30, 2015) (Judge Coleman, III) (concluding that when a debtor's case is not confirmed or converted to chapter 7 the trustee retains authority to disburse funds according to section 1326(a)(2) because *Harris* is not controlling); *In re Ikegwu*, No. 14–17367–DER, 2015 WL 5608357 at *1 (Bankr. D. Md. Sept. 23, 2015) (Judge Rice) (affirming the court's previous decision in *In re Brandon* that *Harris* does not preclude payment of attorney's fees in the case of a pre-confirmation dismissal); *In re Edwards*, 538 B.R. 536, 542 (Bankr. S. D. Ill. 2015) (Judge Grandy) (holding that *Harris* is not controlling in the case of dismissal); *In re Brandon*, 537 B.R. at 235 (holding that *Harris* is not controlling in the case of a pre-confirmation dismissal because dismissal does not terminate the service of the chapter 13 trustee and chapter 13 provisions remain in effect until the case is closed); *In re Kirk*, 537 B.R. 856, 859 (Bankr. N.D. Ohio 2015) (Judge Woods) (holding that *Harris* is not controlling in dismissal because dismissals are not governed by section 348). *But see In re Brown*, 538 B.R. 714, 720 (E.D. Va. 2015) (Judge Mayer) (relying on *Harris* to find that "[u]pon dismissal, all funds that the trustee holds are repaid to the debtor.")
[22] *Harris*, 135 S.Ct. 1829.
[23] 11 U.S.C. § 349.
[24] *Id.* at § 349.
[25] *Id.* at § 103(i).
[26] *In re Kirk*, 537 B.R. at 859 (citations omitted).

dismissal have reached different conclusions, often depending on whether the case was dismissed pre-confirmation or post-confirmation.[27]

A. Pre-Confirmation Dismissal

When a case is dismissed pre-confirmation, a number of courts (both pre- and post-*Harris*) have held that the third sentence of section 1326(a)(2) requires (or permits) the trustee to pay "any unpaid claim allowed under section 503(b)" prior to remitting accumulated funds to a debtor.[28] Although Bankruptcy Code section 349(b)(3) provides that, unless the court others otherwise for cause, dismissal of a case "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the [bankruptcy] case," courts have concluded that the specific directives in section 1326(a)(2) control over the general directive in section 349(b)(3)[29] or that the revesting provision of section 349(b)(3) applies only to the pre-petition estate, having no effect on post-petition plan payments.[30] Other courts have found "cause" under section 349(b) to override the presumptive revesting under section 349(b)(3) based on the statutory directive of section 1326(a)(2).[31]

While it appears that courts generally have agreed that *allowed* section 503(b) expenses may be paid upon pre-confirmation dismissal, chapter 13 debtors' attorneys often are not awarded fees prior to confirmation, raising a variety of issues. Some courts, for example, have refused to compel chapter 13 trustees to pay accumulated funds to debtors' attorneys on the basis of assignments or attorneys' liens when the attorneys failed to seek approval of the fees under section 330 of the Bankruptcy Code.[32] Courts also have disagreed as to whether jurisdiction exists to consider a request for allowance of an administrative claim after a case has been dismissed.[33] One court, which refused to consider a post-dismissal application for compensation, reasoned that "where the court does not explicitly retain [jurisdiction for cause under section 349], the court

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[27] *See, e.g.*, *In re Edwards*, 538 B.R. at 542 (holding that plan payments must be returned to the debtor in the case of post-confirmation dismissal); *In re Kirk*, 537 B.R. at 859-860 (finding that funds should be disbursed according to section 1326(a)(2) and remaining funds should then be returned to the debtor in the case of pre-confirmation dismissal).

[28] *See, e.g., Wheaton*, 547 B.R. at 499; *In re Merovich*, 547 B.R. at 647; *In re Cohen*, 2016 WL 797656 *4-5; *Matter of Hightower*, 2015 WL 5766676 at *5; *In re Ikegwu*, 2015 WL 5608357 at *1; *In re Brandon*, 537 B.R. at 235; *In re Kirk*, 537 B.R. at 859-860; *In re Garris*, 496 B.R. 343, 350 (Bankr. S.D.N.Y. 2013) (Judge Morris); *In re Steenstra*, 307 B.R. 732, 738 (1st Cir. BAP 2004) (Judge Vaughn); *In re Doherty*, 229 B.R. 461, 463–65 (Bankr.E.D.Wash.1999) (Judge Rossmeissl); *In re Oliver*, 222 B.R. 272, 274 (Bankr.E.D.Va.1998) (Judge Bostetter); *see also In re Lewis*, 346 B.R. 89, 104-11 (Bankr E.D. Pa. 2006) (Judge Frank) (holding that section 349(b)(3) is controlling and that bankruptcy estate property revests in the debtor unless the court, for cause, orders otherwise, but also finding that the directives in section 1329(a)(2) provide a sufficient basis to override the presumptive revesting of property under section 349(b)(3)).

[29] *See, e.g., In re Kirk*, 537 at 860.

[30] *See In re Garris*, 496 B.R. at 350.

[31] *See, e.g., In re Lewis*, 346 B.R. at 104-11.

[32] *In re Garris*, 496 B.R. at 353-54 (noting, however, that the debtor could choose to pay the funds to the attorney on receipt); *In re Rogers*, 519 B.R. 267, 271-74 (Bankr. E.D. Ark. 2014) (Judge Taylor).

[33] *See In re Ward*, 523 B.R. 142, 147 (E.D. Wis. 2014) (recognizing split of authority) (citations omitted) (Judge Stadtmueller).

thereafter presumptively lacks jurisdiction over the issue."[34] Another court, which determined that the court had ancillary jurisdiction over fee requests notwithstanding dismissal, opined that requiring attorneys to file fee applications prior to dismissal would create inherent complications to the chapter 13 process.[35]

The courts also have split on the issue of whether a standing chapter 13 trustee may collect from funds received the percentage fee provided for by 28 U.S.C. § 586(e)[36] when the case is dismissed prior to confirmation.[37] Although courts uniformly have found that the silence in sections 586(e)(2) and 1326(a)(2) on this issue creates ambiguity,[38] courts have reached different conclusions when reconciling the ambiguity. On one hand, courts that have required the return of the percentage fee have found "that section 586(e)(2) specifies the source from which the trustee is to collect the percentage fee while section 1326(a) addresses the circumstances under which the trustee must return the collected fee to the debtor. If a case is dismissed prior to the confirmation of a plan, section 1326(a)(2) requires the trustee to return the collected percentage fee to the debtor."[39] On the other hand, courts that have allowed the standing trustee to collect the percentage fee have concluded that the percentage fee is mandatory under section 586 and distinct from payments to creditors "not yet due and owing" that are to be returned to the debtor pursuant to section 1326(a).[40]

B. Post-Confirmation Dismissal

The applicability of section 1326(a)(2) to a plan dismissed post-confirmation is less certain. At least one court has allowed a chapter 13 trustee to disburse plan funds in accordance with the confirmed plan by relying on the second sentence of section 1326(a)(2), which provides that "[i]f a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan as soon as is practicable."[41] An apparent majority of courts, however, have rejected this view, finding that this is a piece-meal reading of section 1326.[42] These courts have held that a reading of section 1326(a) in its entirety demonstrates that section 1326 is limited to funds paid to the chapter 13

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[34] *In re Iannini v. Winnecour*, 487 B.R. 434, 439 (W.D. Pa. 2012) (Judge Hornak).
[35] *In re Garris*, 496 B.R. at 354 (citations omitted).
[36] 28 U.S.C. § 586(e) provides that the trustee shall fix a percentage fee not to exceed ten percent that is collected from all payments *received* by the trustee.
[37] *Compare In re Dickens*, 513 B.R. 906, 915 (Bankr. E.D. Ark. 2014) (Judge Evans) (trustee must disgorge fee for funds not disbursed) *and In re Acevedo*, 497 B.R. 112, 122 (Bankr. D.N.M. 2013) (Judge Jacobvitz and Judge Thuma) (trustee prohibited from collecting fee if no plan is confirmed) *with In re Nardello*, 514 B.R. 105, 111 (Bankr. D.N.J. 2014) (Chief Judge Simandle) (trustee percentage mandatory on *receipt* of payments from debtor).
[38] *See In re Dickens*, 513 B.R. at 912; *In re Nardello*, 514 B.R. at 113.
[39] *In re Dickens*, 513 B.R. at 914. *See also Acevedo*, 497 B.R. at 123-124 (comparing section 1226(a)(2), the chapter 12 counterpart to 1326(a)(2), in which Congress expressly provided for the payment of the percentage fee upon dismissal, pre-confirmation, and determining that Congress could have included a similar provision in chapter 13 if it intended that the trustee retain the percentage fee).
[40] *In re Nardello*, 514 B.R. at 111-113.
[41] *See, e.g., In re Parrish*, 275 B.R. 424, 429 (Bankr. D.D.C. 2002) (Judge Teel, Jr.).
[42] *See In re Edwards*, 538 B.R. at 540 (post-*Harris*). *See also Nash v. Kester (In re Nash)*, 765 F.2d 1410, 1413 n. 1 (9th Cir. 1985) (pre-*Harris*); *Williams v. Marshall (In re Marshall)*, 526 B.R. 695, 697–98 (N.D.Ill.2014) (Judge Hollis) (pre-*Harris*); *In re Hamilton*, 493 B.R. 31, 45-46 (Bankr. M.D. Tenn. 2013) (Judge Lundin) (pre-*Harris*).

trustee *prior to confirmation*, and section 1326 provides no guidance for how the chapter 13 trustee is to dispose of funds paid after the plan was confirmed.[43] Post-*Harris*, at least one court has continued to side with the pre-*Harris* majority.[44]

Notably, section 349(b) begins by providing that property of the estate revests in the debtor "unless the court, for cause, orders otherwise."[45] At least two courts have found that directives in dismissal orders or confirmation orders that provided for accumulated funds to be paid to creditors pursuant to the terms of the confirmed plan on dismissal satisfied the "cause" requirement of section 349(b) and overrode the revesting language of section 349(b)(3).[46] In other cases courts have found "cause" to preclude funds from revesting in a debtor where the debtor acted in "bad faith" or where there were "inequitable' circumstances,"[47] such as the debtor's continued enjoyment of the automatic stay.[48]

IV. The Bankruptcy Courts' Response to *Harris*

Bankruptcy practitioners, trustees, and judges have expressed concern over the practical impact of *Harris,* particularly as to how *Harris* affects compensation of chapter 13 debtors' attorneys and chapter 13 trustees in unsuccessful chapter 13 cases. In response to the *Harris* decision, a number of bankruptcy courts have implemented changes to local rules and administrative orders, as well as to chapter 13 plans and confirmation orders, in efforts to both conform local practice to the *Harris* decision and, in some respects, to avoid its application. Highlighted below are examples of ways in which Eleventh Circuit bankruptcy courts have changed local practice following *Harris.*

A. Northern District of Georgia

By general order dated December 1, 2015, the United States Bankruptcy Court for the Northern District of Georgia directed that a debtor's chapter 13 plan "must state with specificity whether the debtor directs the [c]hapter 13 trustee to pay [the] debtor's attorney from funds being held by the [c]hapter 13 trustee at the time of any conversion of the case prior to or after confirmation of the plan"[49] The general order further provided that "[w]ith this direction from [the] debtor, and appropriate disclosure by [the] debtor's attorney..., the [c]hapter 13 [t]rustee is

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[43] *In re Edwards*, 538 B.R. at 541.
[44] *Id.* at 542.
[45] 11 U.S.C. § 349(b).
[46] *In re Hufford*, 460 B.R. 172, 178 (Bankr. N.D. Ohio 2011) (Judge Speer) (Confirmation order provided: "[I]n the event of a conversion to another chapter or dismissal of this case by the Court or by the debtors pursuant to 11 U.S.C. Section 1307, all funds remaining in the hands of the Trustee at the time of dismissal or conversion shall be paid to the Chapter 13 creditors pursuant to the terms of this confirmed plan."); *In re Cox*, 381 B.R. 525, 528-529 (Bankr. E.D. Tenn. 2008) (Judge Stair, Jr.) ("Dismissal Order expressly directs that "[t]he trustee shall disburse the balance of funds on hand in accordance with the Debtors' confirmed plan.").
[47] *In re Weatherspoon*, No. 11-46755-BDL, 2014 WL 61405, at *4 (Bankr. W.D. Wash. Jan. 3, 2014) (citations omitted) (Judge Lynch).
[48] *In re Torres*, No. 99–02609, 2000 WL 1515170 at *3 (Bankr. D. Idaho Oct. 10, 2000) (Judge Pappas).
[49] Bankr. N.D. Ga. General Order 18-2015, ¶ 3.

authorized to deliver to [the] debtor's attorney the unpaid amount of the agreed upon fees not to exceed (i) $2,000.00 upon a pre-confirmation conversion and (ii) the allowed fees upon a post-confirmation conversion."[50] The above-referenced general order is available at http://www.ganb.uscourts.gov/content/general-order-18-2015, and the district's local plan is available at http://www.ganb.uscourts.gov/ganb-local-forms.

B. Southern District of Florida

By administrative order dated March 11, 2016, the United States Bankruptcy Court for the Southern District of Florida substituted Local Rule 1019-1 with Interim Local Rule 1019-1, finding that exigent circumstances warranted implementation of "amendments...regarding conversion of chapter 13 cases to chapter 7 cases" effective March 11, 2016.[51] This administrative order is available at http://www.flsb.uscourts.gov/. The interim rule adopted thereby provides, in relevant part:

> (E) Disposition of Funds by Chapter 13 Trustee Upon Conversion of Case to Chapter 7. Upon the conversion of a case under chapter 13 of the Bankruptcy Code to chapter 7, the trustee shall dispose of funds remaining after payment to the trustee of approved fees and costs, subject to provisions of subdivisions (F) and (G) of this rule, as follows:
>
> (1) if the conversion occurs pre-confirmation, distribute the balance of the funds to the debtor after first paying
>
> (a) any funds held by the chapter 13 trustee in trust in accordance with any vesting order[52] entered in the case; and
>
> (b) any unpaid claim allowed under 11 U.S.C. §503(b).
>
> (2) if the conversion occurs post-confirmation, distribute the balance of the funds to the debtor after first paying
>
> (a) any administrative creditor that the debtor has directed the chapter 13 trustee pay in accordance with an assignment valid under applicable non-bankruptcy law or other written direction signed by the debtor which assignment or written direction must

[50] *Id.*

[51] Bankr. S.D. Fla. Administrative Order 16-02 at 1.

[52] The Local Rules of the United States Bankruptcy Court for the Southern District of Florida provide that a bankruptcy court may enter "an order pre-confirmation that all pre-confirmation interim payments made to the chapter 13 trustee are vested and non-refundable if the plan is not confirmed and the case is dismissed." Bankr. S.D. Fla. R. 1017-2(F) (providing for the disposition of funds by a chapter 13 trustee upon dismissal of a case).

be filed after the notice of conversion has been filed but no later than seven days after the notice of conversion has been filed; and

(b) to secured creditors any funds that are being held in trust for such secured creditor in accordance with a court approved vesting order.

(3) During the 90 days following the notice of conversion, the trustee shall not distribute any funds that are needed to cover checks issued by the trustee before the notice of conversion was filed. Any checks returned during the 90 day period may not be reissued by the trustee except in accordance with 11 U.S.C. §1326(a)(3), and if there are any checks still unnegotiated 90 days after the notice of conversion was filed the trustee must put a stop payment on those checks.[53]

C. Middle District of Florida

By administrative order signed August 10, 2015, and amended in January and April of 2016, the United States Bankruptcy Court for the Middle District of Florida amended its uniform procedures for chapter 13 cases filed after September 1, 2015.[54] The administrative order is available at http://pacer.flmb.uscourts.gov/administrativeorders/search.asp. Among other things the order provides:

> The [chapter 13] [t]rustee is authorized to pay from [pre-confirmation plan payments] any fees and charges assessed against the estate by law as authorized by § 1326(b) and to collect from all receipts the [t]rustee's fee authorized by 28 U.S.C. § 586 ("Trustee's Commission"). The Trustee's Commission shall be earned upon receipt of each payment from the [d]ebtor and may be distributed to the [t]rustee upon receipt of the payment. The [t]rustee shall hold the remaining funds pending entry of the order confirming the [p]lan, except as set forth in this Order or ordered otherwise.[55]

The order further states that "if [the] [d]ebtor files a notice of conversion of this case to a [c]hapter 7 or the Court orders the conversion of this case to a [c]hapter 11 or its dismissal, any undistributed funds in the [t]rustee's possession on the date of conversion or dismissal shall be payable to

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[53] Bankr. S.D. Fla. Administrative Order 16-02 at 2-3; Bankr. S.D. Fla. R. 1019-1(E).
[54] Bankr. M.D. Fla. Administrative Order FLMB-2015-8; Bankr. M.D. Fla. Administrative Order FLMB-2016-1; Bankr. M.D. Fla. Administrative Order FLMB-2016-2.
[55] Bankr. M.D. Fla. Administrative Order FLMB-2016-2, ¶ 5. Notably, the administrative order authorizes the trustee to make monthly disbursements of adequate protection payments prior to confirmation. *Id.* at ¶ 6.

[d]ebtor and, if [d]ebtor is represented by counsel, mailed to [d]ebtor in care of [d]ebtor's attorney."[56] Also, the order provides for the court's retention of jurisdiction to "review the total amount of attorney's fees requested by or paid to [d]ebtor's attorney" in the event the case is dismissed order converted.[57]

D. Northern District of Alabama

Post-*Harris*, confirmation orders entered in chapter 13 cases in the United States Bankruptcy Court for the Northern District of Alabama routinely provide, "[i]f this case is dismissed, any monies received prior to the order of dismissal shall be distributed according to the confirmed plan. Any monies received after an order of dismissal shall be distributed to the debtor."

E. Southern District of Alabama

Although not a new practice, in the United States Bankruptcy Court for the Southern District of Alabama, chapter 13 debtors routinely assign their rights to receive accumulated funds from the chapter 13 trustee upon dismissal or non-completion to their bankruptcy attorneys.[58] The form contract for legal representation provides that the debtor will remain responsible for any attorney's fees if the case is dismissed or if the chapter 13 plan is not completed.[59] Also, the debtor assigns to the attorney the right to negotiate any refund check on the debtor's behalf and to apply any proceeds from the refund check to any outstanding attorney's fees.[60]

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[56] *Id.* at ¶ 7.
[57] *Id.* at ¶ 17.
[58] Bankr. S.D. Ala. Form Contract for Legal Representation
[59] *Id.* ("It is further understood that should the client be dismissed and/or not complete the case, the client is responsible for the payment of the contracted fee. The client understands that any refund check he/she may receive as a result of dismissal of the case shall be applied to any outstanding fees and the client specifically authorizes the attorney to negotiate said check on the client's behalf.")
[60] *Id.*

Law v. Siegel and Subsequent Case Analysis

Law v. Siegel, __ U.S. __, 134 S.Ct. 1188, 188 L.Ed. 2d 146 (2014):

U.S. Supreme Court overturned 9th Circuit decision allowing Chapter 7 bankruptcy trustee to surcharge debtor's homestead exemption due for costs associated with overcoming debtor's fraudulent misrepresentations. The Court held that whatever sanctions a bankruptcy court may impose on a dishonest debtor, it may not contravene express provisions of the Bankruptcy Code by ordering that the debtor's exempt property be used to pay debts and expenses for which that property is not liable under the Bankruptcy Code.

Mateer v. Ostrander (In re Mateer), 525 B.R. 559 (Bankr. D. Mass. 2015):

Debtor who intentionally failed to disclose the existence of his insurance claim and cash payments received from the mortgage lender and insurer was permitted to exempt only some of the proceeds and remainder was turned over to the Chapter 7 trustee. The Court noted that up until *Siegel*, it would have denied entire exemption because of debtor's attempt to conceal the claim and payments.

In re Pratts, 2015 Bankr. LEXIS 1800 (Bankr. D.P.R. June 1, 2015):

Debtor acting in bad faith when he failed to describe his actual interest in real property in original bankruptcy schedules was permitted to amend Schedule C and claim exemptions under 11 U.S.C. § 522 over Chapter 7 Trustee's objection.

In re Castellano, 2016 Bankr. LEXIS 1824 (Bankr. E.D.N.Y. Apr. 25, 2016):

While noting that debtor was not to be applauded for his conduct, the Court overruled exemption objection by Chapter 7 trustee after debtor converted non-exempt cash into exempt IRA on the eve of filing bankruptcy.

In re Headlee Mgmt. Corp., 519 B.R. 452 (Bankr. S.D.N.Y. 2014):

Chapter 11 professionals allowed to retain interim fees paid before conversion to Chapter 7 because there was no authority to disgorge under 11 U.S.C . §§ 726(a) or 105(a), or any other Bankruptcy Code provision. While some instances may warrant disgorgement, the U.S. Trustee and Chapter 7 Trustee agreed that these professionals earned their awarded fees.

Bonidie v. PV & JC DeBlasio (In re Bonidie), 2014 Bankr. LEXIS 4852 (Bankr. W.D. Pa. Nov. 25, 2014):

Debtors were allowed to claim full value of their homestead exemption while avoiding judicial lien because lienholders' request for surcharge failed to identify a Bankruptcy Code section permitting a surcharge.

In re Dunaway, 2015 Bankr. LEXIS 819 (Bankr. N.D. W.Va. Mar. 16, 2015):

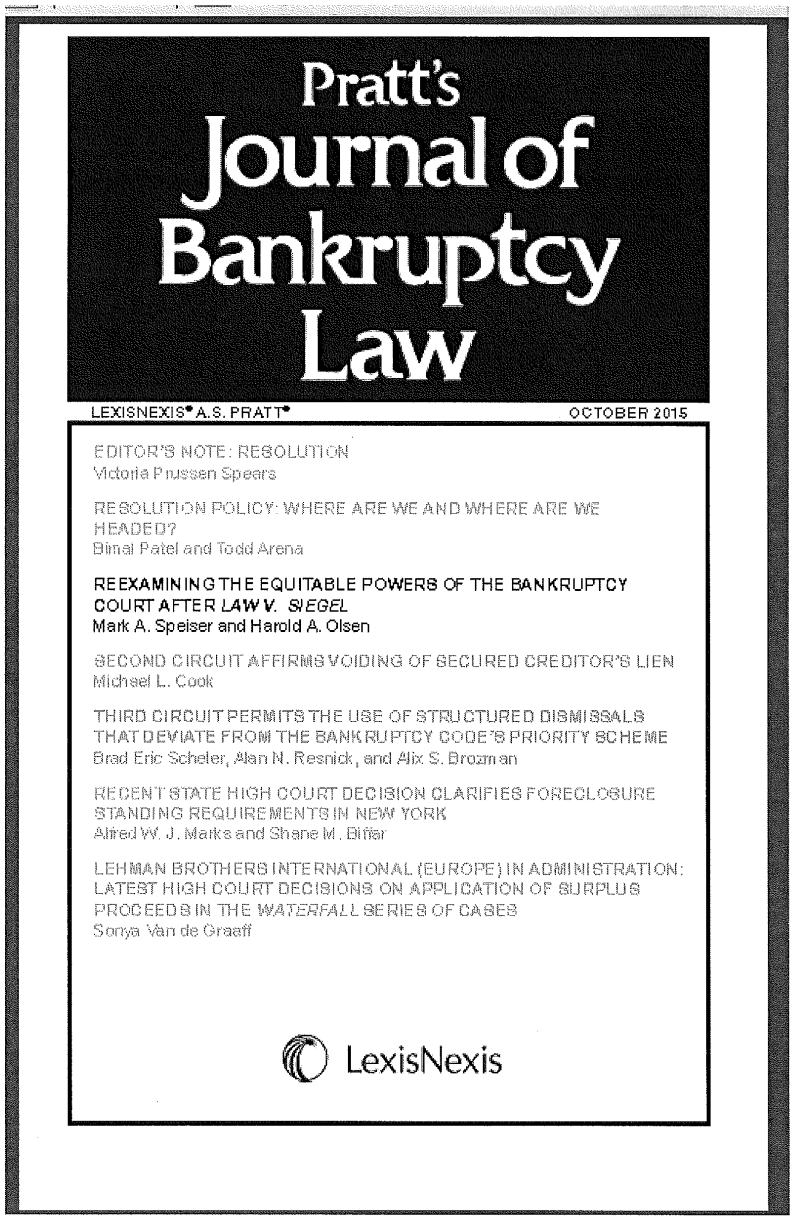
Bankruptcy court refused to deny debtor's amended claim of exemptions based on Chapter 7 trustee's claim of laches because this equitable doctrine does not restrict the debtor's otherwise unfettered ability to amend his claimed exemptions at any time before closure of the case.

Ellman v. Baker (In re Baker), 791 F.3d 677 (6th Cir. 2015):

Chapter 7 trustee failed to object to timeliness of amendments and debtors were allowed to re-open case and amend exemptions years after close of the bankruptcy case.

In re Saldana, 531 B.R. 141 (Bankr. N.D. Tex. 2015):

Debtor was allowed to claim homestead exemption in some, but not all of land parcels. Under 11 U.S.C. § 105, the bankruptcy court sanctioned debtor in form of fee shifting. The bankruptcy court also noted that possibility remained open that state law may offer some independent basis to disallow an otherwise appropriate exemption created under state law.



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Reexamining the Equitable Powers of the Bankruptcy Court After *Law v. Siegel*

By Mark A. Speiser and Harold A. Olsen*

In this article, the authors consider the extent of bankruptcy court equitable powers, and the impact of Law v. Siegel, *in three contexts: first, whether the bankruptcy court may "equitably disallow" an otherwise valid claim; second, the extent of the bankruptcy court's equitable discretion in deciding whether to permit a setoff; and third, the bankruptcy court's equitable power to "recharacterize" a purported debt as equity.*

It has long been held that "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity."[1] Bankruptcy courts often have relied on their equitable powers to carry out bankruptcy policies of providing a "breathing spell" and a "fresh start" for debtors, maximizing creditor recoveries and ensuring equal treatment of similarly situated creditors.[2]

However, it is also well-settled that the equitable power of bankruptcy courts is not limitless. Section 105(a) of the U.S. Bankruptcy Code[3] provides that the bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." The equitable power under Section 105(a) must be exercised within the confines of the Bankruptcy Code, and not in contravention of it.[4]

The question in many cases, therefore, is how far the bankruptcy court may go in exercising its equitable powers. In *Law v. Siegel*,[5] the U.S. Supreme Court considered whether a Chapter 7 trustee could surcharge the debtor's exempt

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* Mark A. Speiser is a partner at Stroock & Stroock & Lavan LLP, where he represents institutional creditors and creditors' committees in large and complex reorganization proceedings. Harold A. Olsen is special counsel at the firm, practicing in the area of bankruptcy and financial restructuring. The authors may be contacted at mspeiser@stroock.com and holsen@stroock.com, respectively.

[1] *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934).

[2] *See Musso v. Ostashko*, 468 F.3d 99, 104 (2d Cir. 2006).

[3] 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code").

[4] *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of" the Bankruptcy Code); *In re Smart World Techs., LLC*, 423 F.3d 166, 184 (2d Cir. 2005) (Section 105(a) does not constitute a "roving commission to do equity").

[5] 134 S. Ct. 1188 (2014).

property for legal fees the trustee incurred as a result of the debtor's fraudulent misconduct. Law, the debtor, claimed a $75,000 homestead exemption on his home, and reported two liens on the home in his bankruptcy schedules, securing claims that exceeded the non-exempt value of the home, leaving nothing for unsecured creditors. The bankruptcy trustee challenged one of the liens, and the court ultimately concluded that it was a fraud on the creditors and the court.[6] The court determined that the bankruptcy trustee had spent over $500,000 in attorneys' fees in exposing the fraudulent lien, and surcharged Law's exempt interest in the home to pay a portion of those fees. The bankruptcy appellate panel and the circuit court affirmed, holding that the bankruptcy court had equitable power to surcharge exempt property in circumstances such as fraud, to protect the integrity of the bankruptcy process.[7]

The Supreme Court reversed. While acknowledging the equitable powers of the bankruptcy court under Section 105(a), as well as the bankruptcy court's inherent power to sanction abusive litigation practices, the Court held that those powers may not be exercised in a way that contravenes specific statutory provisions.[8] Section 522 of the Bankruptcy Code permitted the debtor to take the exemption under applicable state law, and provided that (subject to two exceptions that were not applicable under the facts of the case) such exempt property was "not liable for payment of any administrative expense."[9] Accordingly, the bankruptcy court could not rely on its equitable powers to surcharge exempt property in the face of an express statutory prohibition. Moreover, the Court noted that Section 522 contains "a number of carefully calibrated exceptions and limitations," the existence of which confirms that the bankruptcy court is not empowered to create additional exceptions.[10]

In this article, we consider the extent of bankruptcy court equitable powers, and the impact of *Law v. Siegel*, in three contexts: first, whether the bankruptcy court may "equitably disallow" an otherwise valid claim; second, the extent of the bankruptcy court's equitable discretion in deciding whether to permit a setoff; and third, the bankruptcy court's equitable power to "recharacterize" a purported debt as equity.

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[6] *Id.* at 1193.

[7] *Id.* at 1194.

[8] *Id.*

[9] *Id.* at 1195 (quoting 11 U.S.C. § 522 (k)).

[10] *Id.* at 1196. The Court noted that applicable state exemption law might provide grounds to deny the exemption on equitable grounds, which would not be precluded by the Court's ruling. Rather, it was reliance on a general, federal equitable power that the Court found objectionable. *See id.* at 1196–97.

EQUITABLE DISALLOWANCE

Can the bankruptcy court disallow a claim on equitable grounds where none of the statutory grounds for disallowance under Section 502(b) of the Bankruptcy Code applies? A number of recent decisions have said no, but the cases are not unanimous.

In *Pepper v. Litton*,[11] the Supreme Court examined the extent of this equity power in the context of Section 2 of the Bankruptcy Act of 1898. Noting that Section 2 granted bankruptcy courts "such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings," the Court observed that by virtue of Section 2 "the bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the act, it applies the principals and rules of equity jurisprudence."[12] Because the powers granted by Section 2 included the power to allow and disallow claims, the power to reject claims previously allowed "according to the equities of the case," and the power to enter such judgments as may be necessary to enforce the provisions of the Bankruptcy Act, the bankruptcy court was authorized to exercise equitable powers in the allowance of claims.[13] The Supreme Court found that the defendant, Litton, had engaged in a "planned and fraudulent scheme" to frustrate a creditor of his wholly owned corporation by strategic assertion of claims that appeared to be mere bookkeeping entries, while causing the company to confess judgment in his favor, which he then used strategically to ultimately shift most of the assets of the corporation to a sister company without adequate consideration.[14] Although the judgment appealed from is described as a disallowance of Litton's claim, the Court repeatedly refers to "disallowance or subordination" of the claims.

Pepper v. Litton has often been cited for the proposition that the bankruptcy court is a court of equity, but the idea of "equitable disallowance" as a distinct concept from equitable subordination does not appear to have gained much traction in ensuing years. In 1978, the Bankruptcy Code was enacted. Section 510(c) of the Bankruptcy Code incorporates equitable subordination, but not equitable disallowance. Section 502 of the Bankruptcy Code governs the allowance of creditor claims against the bankruptcy estate. Section 502(a) of the Bankruptcy Code generally provides that a claim filed by a creditor is deemed

[11] 308 U.S. 295 (1939).

[12] *Id.* at 303–04.

[13] *Id.* at 305.

[14] *See id.* at 297–302.

allowed, unless a party in interest objects to the claim. If an objection is filed, Section 502(b) of the Bankruptcy Code provides that the bankruptcy court shall determine the amount of such claim, and shall allow the claim in such amount, except to the extent that one of the enumerated grounds for disallowance applies.

In *In re Adelphia Communications Corp.*,[15] the court, relying on *Pepper v. Litton*, refused to dismiss claims for equitable disallowance under the Bankruptcy Code. The Creditors' Committee asserted numerous claims on behalf of the bankruptcy estate, including equitable subordination and equitable disallowance, against the debtors' bank lenders and investment banks. These claims generally alleged wrongdoing by defendants in their dealings with the debtors' former management, whom the debtors accused of looting the company. The claims included aiding and abetting breaches of fiduciary duty, avoidance of transfers under Chapter 5 of the Bankruptcy Code, and equitable subordination or equitable disallowance of defendants' claims.[16]

The defendants moved to dismiss the equitable disallowance claim for failure to state a claim upon which relief can be granted. The court analyzed (i) whether the existence of Section 510(c) of the Bankruptcy Code, which expressly authorizes equitable subordination, forecloses a claim for equitable disallowance, and (ii) if it does not, whether equitable disallowance was authorized under pre-Bankruptcy Code case law, and survived the enactment of the Bankruptcy Code.[17]

The court first concluded that Section 510(c) did not foreclose a claim for equitable disallowance, primarily relying on an excerpt of legislative history stating that Section 510(c) was intended to codify existing case law (including *Pepper v. Litton*), and was "not intended to limit the court's power in any way . . . [and does not] preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances."[18] The court also invoked "[t]he normal rule of statutory construction . . . that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."[19]

After concluding that Section 510(c) did not foreclose a claim for equitable

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[15] 365 B.R. 24 (Bankr. S.D.N.Y. 2007), *aff'd in part*, 390 B.R. 64 (S.D.N.Y. 2008).

[16] *Id.* at 32.

[17] *Id.* at 71.

[18] *Id.* (quoting H.R. Rep. No. 595, 95th Cong., 1st Session 359 (1977), 1978 U.S.C.C.A.N. pp 5963, 6315).

[19] *Id.* (quoting *Midlantic Nat'l Bank v. N.J. Dept. of Envtl. Prot.*, 474 U.S. 494, 501 (1986)).

disallowance, the court went on to consider "the extent to which *Pepper*, or other applicable common law, supports equitable disallowance, as contrasted to equitable subordination."[20] The court observed that while *Pepper v. Litton* is often thought of as an equitable subordination case, the Court affirmed an order equitably disallowing a claim, and the *Pepper v. Litton* court repeatedly referred to "disallowance or subordination" in the disjunctive, suggesting it recognized them as distinct claims.[21] Accordingly, equitable disallowance was permissible under *Pepper v. Litton*, and in view of the perceived silence of the Bankruptcy Code on the issue, this result was presumed to have carried over under the Bankruptcy Code, so the claim survived a motion to dismiss.[22]

Three subsequent bankruptcy court decisions, including two in the Southern District of New York, have disagreed with *Adelphia*.[23] One basis for this disagreement concerns Section 502 of the Bankruptcy Code, discussed above. Section 502(b) provides that, unless one of the enumerated grounds exists to disallow a claim, the claim shall be allowed. To permit disallowance of a claim on equitable grounds, when that claim would be allowable under the express terms of Section 502(b), seems to be an enlargement of judicial power beyond what Congress envisioned in Section 502-effectively adding an equitable "catch all" provision to the statute.[24]

Lightsquared was decided while *Law v. Siegel* was pending before the Supreme Court. The *Lightsquared* court observed that the Supreme Court's decision in *Law v. Siegel* would have great bearing on the equitable disallowance question.[25] *Madoff* and *TMST*, both decided after *Law v. Siegel*, rely on the Supreme Court's decision in concluding there is no equitable power to disallow an otherwise valid claim.[26]

The power of a bankruptcy court to disallow claims pursuant to its general equitable powers is questionable in light of *Law v. Siegel* and the bankruptcy court decisions discussed above. *Pepper v. Litton* interpreted language in the

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[20] *Id.* at 72.

[21] *Id.* at 73

[22] *Id.*

[23] *See Picard v. Merkin (In re Bernard L. Madoff Inv. Secs. LLC)*, 515 B.R. 117, 156–57 (Bankr. S.D.N.Y. 2014); *Sher v. JPMorgan Chase Funding Inc. (In re TMST, Inc.)*, 518 B.R. 329, 355–57 (Bankr. D. Md. 2014); *Harbinger Capital Partners LLC v. Ergen (In re Lightsquared, Inc.)*, 504 B.R. 321, 341–44 (Bankr. S.D.N.Y. 2013).

[24] *See Lightsquared*, 504 B.R. at 340.

[25] *See Lightsquared*, 504 B.R. at 341–42.

[26] *See Madoff*, 515 B.R. at 157; *TMST*, 518 B.R. at 357.

1898 Bankruptcy Act, which was not entirely carried over into the Bankruptcy Code. Moreover, the lower court had found that the insider wage claims at issue were not valid, but were mere bookkeeping entries, which under the Bankruptcy Code would likely lead to disallowance under the express provisions of Section 502[27] without the need to resort to equity. Although the Bankruptcy Code has no equitable "catch all" provision to disallow claims, it does contain express mechanisms, including equitable subordination of claims under Section 510(c), to avoid unjust results.

Disallowance and subordination are not the same thing: disallowance means the claim is not entitled to any distribution, whereas subordination is, at least in theory, a less drastic remedy-the claim is not disallowed, but any recovery on it is subordinated to claims of creditors, to the extent necessary to redress the harm caused by the subordinated creditor's inequitable conduct.[28] Equitable subordination was incorporated into the Bankruptcy Code, while equitable disallowance was not. Pursuant to Section 510(c), a claim can be equitably subordinated to other claims, and an equity interest can be equitably subordinated to other equity interests. This provision does not authorize the equitable subordination of a claim to equity interests,[29] but the effect of disallowing an otherwise valid claim on purely equitable grounds is potentially to permit equity to receive a distribution when the disallowed creditor will not. Thus, equitable disallowance can be viewed as undercutting the limitations on the remedy actually sanctioned by Congress, equitable subordination. In light of the provisions of Sections 502(b) and 510(c), the legal basis for equitable disallowance under the Bankruptcy Code, as well as the standards for imposing it, are unclear.

SETOFF

Section 553 of the Bankruptcy Code provides in part:

> [e]xcept as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such

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[27] *See* 11 U.S.C. § 502(b)(1) (disallowing claims that are unenforceable against the debtor under applicable non-bankruptcy law).

[28] *See, e.g., Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986–87 (3d Cir. 1998); *In re Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997); *In re Herby's Foods, Inc.*, 2 F.3d 128, 131 (5th Cir. 1993); *Benjamin v. Diamond (In re Mobile Steel)*, 563 F.2d 692, 699–700 (5th Cir. 1977).

[29] *See, e.g., Lightsquared*, 504 B.R. at 342 n.28.

> creditor against the debtor that arose before the commencement of the case[.]

Thus, subject to the certain express exceptions, Section 553 acts to preserve otherwise-valid rights of mutual setoff in bankruptcy.[30]

Numerous cases have stated the general proposition that setoff in bankruptcy is permissive rather than mandatory, and that allowance of setoff is committed to the discretion of the bankruptcy court in the exercise of its equitable powers.[31] In *Cascade Roads*, the Ninth Circuit rejected an argument that equitable discretion to deny setoff must have a basis in non-bankruptcy law, relying on prior case law and its interpretation of Congressional intent in enacting Section 553 to restrict the breadth of the analogous provision of the former Bankruptcy Act.[32]

This line of cases is also called into question by *Law v. Siegel*. Section 553 states that, subject to particular exceptions, the Bankruptcy Code does not affect a creditor's right to setoff mutual prepetition claims. Like the Bankruptcy Code provision at issue in *Law v. Siegel*, Section 553 has no equitable "catch all" exception, and these courts have relied on existing case law and interpretations of legislative intent to support such a broad equitable power under Section 553. Tellingly, the *Collier* treatise, which in previous editions lent support to broad equitable discretion under Section 553, now takes the following view:

> The Bankruptcy Code provides no general equitable mechanism for disallowing rights of setoff that are expressly preserved by section 553. Consistent with the text of section 553, the best statement of modern law and practice is that, if the relevant claim and debt constitute mutual obligations within the meaning of section 553, a right of setoff should be recognized in bankruptcy unless the right is invalid in the

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[30] *See United States v. Norton*, 717 F.2d 767, 772 (3d Cir. 1983) (Section 553 "is not an independent source of law governing setoff; it is generally understood as a legislative attempt to preserve the common-law right of setoff arising out of non-bankruptcy law.").

[31] *See, e.g., In re Cascade Roads, Inc.*, 34 F.3d 756, 763 (9th Cir. 1994) (setoff under Section 553 is permissive, not mandatory, and the court exercises its discretion to allow setoff under general principles of equality); *In re Ace Sports Mgmt., LLC*, 271 B.R. 134, 143 (Bankr. E.D. Ark. 2001) ("Even if setoff is authorized, the bankruptcy court has discretion to deny setoff where principles of equity so dictate"); *In re Nuclear Imaging Systems, Inc.*, 260 B.R. 724, 739 (Bankr. E.D. Pa. 2000) ("Generally, courts have disallowed an otherwise valid common law right of setoff in compelling circumstances, where the creditor has committed inequitable, illegal or fraudulent acts, or the application of setoff would violate public policy") (internal quotations and citations omitted).

[32] *See id.*, 34 F.3d at 764 & n.9.

> first instance under applicable nonbankruptcy law, or unless it is otherwise proscribed by some express provision of the Code. There remains no general equitable power to disallow a valid right of setoff preserved under section 553.[33]

A recent case from the Eleventh Circuit[34] illustrates differing views on the bankruptcy court's equitable powers in the setoff context. In *In re Acosta-Garriga*, the creditor held a prepetition claim against the estate, but was found liable for damages arising from the creditor's violation of the Florida Consumer Collection Practices Act ("FCCPA") while attempting to collect the debt.[35] The bankruptcy court refused to permit the creditor to setoff the FCCPA liability against its claim, reasoning that (i) the debt and claim lacked mutuality under Florida law, and (ii) public policy and "the equities" disfavored setoff of FCCPA debts.[36] The bankruptcy court reasoned that permitting setoff would permit lenders to violate the FCCPA with impunity, instead of incentivizing them to undertake good collection practices, and would inequitably reward them by permitting them "a shortcut in the collection process when they have violated the law."[37]

The district court reversed, concluding that the debt and claim satisfied the requirements for valid setoff under both Section 553 of the Bankruptcy Code and Florida law.[38] This ended the inquiry for the district court, which stated that there is "no general equitable power to disallow a valid right of setoff preserved under section 553."[39]

On further appeal, the Eleventh Circuit reversed the district court in an unpublished decision. The circuit started with the premise that "the right to set off is not absolute. Whether to allow set off is a decision that lies within the sound discretion of the bankruptcy court."[40] The circuit found no abuse of discretion by the bankruptcy court in refusing to allow the setoff. First, it agreed with the bankruptcy court that Florida law was silent on whether an obligation

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[33] Collier on Bankruptcy, § 553.02 (16th Ed. 2015).

[34] *Brook v. Chase Bank (USA), N.A. (In re Acosta-Garriga)*, 506 B.R. 149 (M.D. Fla. 2013), *rev'd*, 566 Fed. Appx. 787 (11th Cir. 2014) (per curiam).

[35] *Acosta-Garriga*, 506 B.R. at 150–51.

[36] *Id.* at 151.

[37] *Id.* at 155.

[38] *Id.* at 152–56.

[39] *Id.* at 151 (quoting 5 Collier on Bankruptcy, § 553.02[3] (16th Ed. 2013)).

[40] *Brook v. Chase Bank USA, N.A.*, 566 Fed. Appx. 787, 789 (11th Cir. 2014).

under FCCPA could be setoff against a prepetition debt.[41] The circuit rejected the district court's reasoning that the setoff would be allowed under general setoff principles of Florida law.

Instead, Florida law's silence on the specific question of whether a debt under FCCPA could be setoff meant that the decision was entirely discretionary with the bankruptcy court—"[a]s long as Florida law neither mandates nor prohibits set off under the FCCPA—and it does not—it is entirely within the bankruptcy court's discretion whether to allow set off under the circumstances of this case."[42] Here, the bankruptcy court reasoned that to allow setoff would undermine the purpose of the FCCPA, a determination the circuit found to be well within the sound discretion of the court.[43]

The Eleventh Circuit couched its decision in terms of the discretionary power of the bankruptcy court in allowing setoff, but reviewed that exercise of discretion in the context of the perceived silence of Florida law on the precise issue of whether FCCPA liabilities may be offset. It thus did not appear to hold that the bankruptcy court had discretion to disallow a setoff that was clearly allowable under state law. Nevertheless, given the bankruptcy court's focus on the policy behind the FCCPA, it is unclear that the discretion employed in the case was a broad exercise of equitable power to avoid an unfair result, or a narrower focus on carrying out the intent of the FCCPA.[44]

Where a setoff is valid under nonbankruptcy law, and meets the requirements of Section 553, it is questionable whether the bankruptcy court may disallow it on equitable grounds.[45] Section 553 provides that, except as specifically provided otherwise in Sections 362, 363 and 553 itself, the Bankruptcy Code "does not affect" the right of a creditor to exercise such a setoff right. In light of these specific exceptions, *Law v. Siegel* would suggest there can be no additional, equitable "catch all" preventing the exercise of a valid setoff.

RECHARACTERIZATION

Many courts have recognized the power of the bankruptcy court to

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[41] *Id.*

[42] *Id.* at 790.

[43] *Id.*

[44] *See id.* ("[t]he bankruptcy court exercised its discretion to deny set off here reasoning that the stated purpose of the FCCPA would be undermined if set off was allowed. Such a determination is well within the sound discretion of the court").

[45] As with equitable disallowance, the standards for denying setoff based on general equitable grounds are unclear.

"equitably recharacterize" a purported loan as in reality an equity contribution.[46]

What is the source of the bankruptcy court's authority to recharacterize debt as equity? A number of circuits have relied on the court's equitable powers under Section 105(a) of the Bankruptcy Code.[47] Other courts have found the authority to recharacterize in Section 502(b), rather than Section 105(a), of the Bankruptcy Code.[48] Section 502(b)(1) provides an exception to the allowability of claims where the claim is unenforceable under applicable law. Accordingly, these courts look to applicable state law as the basis for any recharacterization.[49]

The source of authority for recharacterization is unclear, as these conflicting circuit court authorities demonstrate. Is it simply an exercise of the court's inherent equity powers? Is it impermissible given that Section 510(c) of the Bankruptcy Code provides for equitable subordination with a similar, though not identical, result? Or is it only permissible as part of a Section 502(b) analysis of claim allowability under applicable nonbankruptcy law?[50] The Tenth Circuit, in its *Alternate Fuels* decision, concluded that neither *Law v. Siegel* nor another Supreme Court precedent, *Travelers Cas. & Surety Co. of Am. V. Pacific Gas & Elec. Co.*,[51] undercut its reliance on Section 105(a) as a basis for recharacterization.[52] Neither of those cases addressed recharacterization. Moreover,

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[46] *See, e.g., In re Autostyle Plastics, Inc.*, 269 F.3d 726, 747–48 (6th Cir. 2001); *Sinclair v. Barr (In re Mid-Town Produce Terminal, Inc.)*, 599 F.2d 389, 393 (10th Cir. 1979).

[47] *See In re Alternate Fuels, Inc.*, 789 F.3d 1139, 1146–49 (10th Cir. 2015); *AutoStyle*, 269 F.3d at 747–53; *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 455 n. 8 (3d Cir. 2006); *Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 233–34 (4th Cir. 2006).

[48] *See In re Lothian Oil Inc.*, 650 F.3d 539, 542–44 (5th Cir. 2011), *cert. denied*, 132 S.Ct. 1573 (2012); *accord In re Fitness Holdings Int'l, Inc.*, 714 F.3d 1141, 1148–49 (9th Cir. 2013).

[49] *See Lothian*, 650 F.3d at 544; *Fitness Int'l*, 714 F.3d at 1149.

[50] *Cf. Law v. Siegel*, 134 S. Ct. at 1196–97 (rejecting broad equitable power to deny exemptions, but noting that a state-created exemption may be limited under state law in instances of debtor misconduct).

[51] 549 U.S. 443 (2007). In *Travelers*, the Supreme Court rejected a Ninth Circuit rule disallowing unsecured contractual claims for attorney fees that were based on litigating bankruptcy issues, noting that Section 502(b) contained no such distinction, and there was no basis in the Bankruptcy Code for such a rule. *Travelers*, 549 U.S. at 451–52.

[52] *Alternate Fuels*, 789 F.3d at 1147–49. In another recent decision, the Bankruptcy Court for the District of Minnesota questioned the viability of equitable recharacterization in light of the *Law v. Siegel* decision, but ultimately concluded that even if the doctrine is viable, it would not be warranted under the facts of that case. *See Seaver v. Ashenfelter (In re MSP Aviation, LLC)*,

> *Travelers* held simply that claims enforceable under state law will be allowed in bankruptcy unless they are expressly disallowed. *Travelers* does not prohibit a court from proceeding to a second step in its analysis, to determine whether an otherwise allowed claim fails in bankruptcy because it involves transactions properly characterized as equity. And *Law* held simply that a court may not employ §105(a) to override other explicit mandates of the Bankruptcy Code. Here, no explicit mandate of the Bankruptcy Code prohibits recharacterization under § 105(a).[53]

It is questionable whether the distinction between allowance and recharacterization is a valid basis to justify recharacterization under Section 105(a) if the claim would be respected as a claim under nonbankruptcy law. By recharacterizing a claim as equity, the court effectively disallows the claim against the estate.

CONCLUSION

The *Law v. Siegel* decision has prompted a reexamination of the scope and basis for the bankruptcy court's equity powers in several areas. Although it is often possible to find an early case or cases expounding a broad view of the bankruptcy court's equitable power in a given area, many courts have recently taken the approach of *Law v. Siegel*, seeking to identify a particular basis for that power in bankruptcy or non-bankruptcy law, and limiting its exercise to maintain consistency with the express provisions of the Bankruptcy Code.

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531 B.R. 795, 804–6 (Bankr. D. Minn. 2015).

[53] *Alternate Fuels*, 789 F.3d at 1149.