Bankruptcy

Institute Manual 2018

Minnesota Continuing
Legal Education

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The 2018 Bankruptcy Institute

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2018 Bankruptcy Institute Case Law Update

A review of the opinions of the Supreme Court of the United States, the United States Court of Appeals for the Eighth Circuit, the United States Bankruptcy Appellate Panel for the Eighth Circuit, the United States District Courts for the District of Minnesota, and the United States Bankruptcy Courts for the District of Minnesota, issued after those cases presented at the 2017 Bankruptcy Institute through generally, with some exceptions, August 2018, that affect the general practice of bankruptcy or closely related debt issues.

With a few exceptions, the case summaries were provided by the Bankruptcy Bulletin, a publication of the Minnesota State Bar Association. These materials should neither be relied on nor cited.

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JURISDICTION/APPEALS

1. Allison, et. al v. Centris Federal Credit Union, No. 16‑3923 (8th Cir. Mar. 16, 2018) (Kelly, J.).

TRIAL COURT ON REMAND IS BOUND BY PRIOR FINDINGS OF FACT ONLY TO THE EXTENT APPELLATE COURT ADOPTED FINDINGS

The Eighth Circuit Court of Appeals determined that a successor bankruptcy judge did not exceed the BAP's mandate on remand by re-visiting findings of fact that the BAP's decision declined to resolve. The court further determined that the law-of-the-case doctrine did not require the successor judge to follow the prior bankruptcy judge's findings of fact.

A dispute arose between a group of investors and both a secured creditor and a chapter 11 trustee regarding whether funds recovered by the trustee were property of the estate. The bankruptcy judge determined that the funds were held in trust and not part of the debtor's bankruptcy estate. The secured creditor and the chapter 11 trustee appealed to the BAP, which reversed and remanded for further proceedings while declining to reach the issue of whether the funds were property of the estate.

As the first bankruptcy judge had retired, on remand the matter was reassigned to a successor judge. The successor judge concluded that the funds were in fact loan proceeds and property of the bankruptcy estate.

The investors appealed to the BAP and asserted that the successor judge had exceeded the scope of the BAP's prior mandate and violated the law of the case doctrine. The BAP remanded and required the successor judge to certify her familiarity with the record and give the parties an opportunity to recall witnesses pursuant to Fed. R. Civ. P. 63 and Fed. R. Bankr. P. 9028. The judge did so and entered an order again concluding that the funds were property of the estate.

The investors' appeal of that order to the district court was affirmed. The investors then appealed to the Eighth Circuit. The Eighth Circuit affirmed the district court and reasoned that a trial court is bound by its own prior rulings only to the extent the appellate court explicitly or implicitly adopted those findings in resolving the appeal. As the BAP had explicitly declined to adopt a finding with regard to whether the funds were property of the estate, the trial court was not bound by that prior ruling. And as the successor judge steps into the shoes of his or her predecessor, with the same freedom as the first judge, the successor was not bound by the ruling of the first judge.

2. Marshall v. ECMC et al. (In re Marshall), 723 Fed.Appx. 384 (8th Cir., May 23, 2018)

EIGHTH CIRCUIT AFFIRMS DISMISSAL OF UNTIMELY APPEAL FOR LACK OF JURISDICTION

The Eighth Circuit Court of Appeals reviewed the BAP's dismissal of an untimely appeal for lack of jurisdiction. In the underlying case, the bankruptcy court overruled the debtor's objection to the proof of claim of ECMC and MOHELA, its successor, and denied the debtor's emergency motion to invalidate the transfer of claim by ECMC to MOHELA. The debtor filed a motion to require the bankruptcy court to reduce its oral findings on those matters to writing, and appealed to the BAP. The BAP dismissed the appeal for lack of jurisdiction because the debtor's notices of appeal of those orders were untimely. Unless an exception applies, Rule 8002(a) requires a notice of appeal be filed within 14 days after entry of the judgment or order being appealed. The debtor did not file notices of appeal until after the expiration of that 14-day deadline. Rule 8002(b) lists the types of motions that, if timely filed, toll the deadline for filing a notice of appeal. Those are a motion to amend or make additional findings under Rule 7052, to amend the judgment, for a new trial, or for relief from judgment or order. The BAP concluded that the debtor's motion to require the bankruptcy court to reduce its oral findings to writing was not within the parameters of Rule 7052, and therefore, did not toll the debtor's 14-day deadline. On appeal, the Eighth Circuit per curiam affirmed the BAP's dismissal for lack of jurisdiction due to the untimely appeal filings. Having determined on de novo review that the BAP did not err, it further observed that nothing in the record would support equitable tolling and declined to address whether the debtor's motion qualified as one under Rule 7052.

3. McDougall v. AgCountry Farm Credit Servs. (In re McDougall), 587 B.R. 87 (B.A.P. 8th Cir. Jul. 9, 2018) (Schermer, J.).

BANKRUPTCY COURT LACKED "RELATED TO" JURISDICTION OVER STATE LAW DISPUTE BETWEEN NON-DEBTORS AND A MORTGAGEE AS DISPUTE HAD NO "CONCEIVABLE EFFECT" ON BANKRUPTCY ESTATE

The Eighth Circuit Bankruptcy Appellate Panel remanded a proceeding back to the bankruptcy court for dismissal, holding that the bankruptcy court lacked jurisdiction to consider the state law dispute between non-debtors and a mortgagee.

The debtors filed an adversary proceeding against non-debtors and a mortgagee concerning a mortgage and an ownership interest in land that was not property of the estate as of the petition date. The non-debtors answered, asking the bankruptcy court to invalidate the mortgage based on fraud, but the non-debtors filed no cross-claim against the mortgagee and no counterclaim against the debtors. The bankruptcy court ruled that the mortgage was enforceable and entered judgment for the mortgagee and against the debtors. The ruling effectively also determined the nature of the non-debtors' rights in the mortgaged property. The non-debtors appealed, challenging the judgment on the basis of state law fraud and challenging the validity of the mortgage.

On appeal, the BAP initially recognized its independent duty to examine bankruptcy court jurisdiction. "Bankruptcy courts, by reference from the district courts, have "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." Acknowledging that the non-debtors brought no cross-claim or counterclaim in the matter, the BAP determined that the bankruptcy court had no "arising under" or "arising in" jurisdiction over the non-debtors' state law claim, which was not created under the Bankruptcy Code and could exist outside of bankruptcy.

The BAP then examined "related to" jurisdiction. To determine "related to" jurisdiction, courts in the Eighth Circuit apply the "conceivable effect" test, which "is whether the outcome of that proceeding could conceivably have any effect on the estate being administered in the bankruptcy. . . . An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action . . . and which in any way impacts upon the handling and administration of the bankruptcy estate." Applying the conceivable effect test for related to jurisdiction, the BAP determined that the alleged dispute was between two non-debtors about property that was never property of the bankruptcy estate and that the outcome of the dispute would have no effect on the bankruptcy estate. The BAP remanded the matter back to the bankruptcy court with instructions to dismiss for the lack of jurisdiction.

ABSTENTION

4. Zahn Law Firm, P.A. v. Ronald Stuart Baker (In re Baker), 577 B.R. 308 (B.A.P. 8th Cir., November 16, 2017) (Nail, J.).

A SINGLE ERROR IN APPLYING THE SIXTEEN FACTOR ANALYSIS TO DETERMINE WHETHER TO REMAND A CASE TO STATE COURT IS NOT AN ABUSE OF DISCRETION

The Eighth Circuit Bankruptcy Appellate Panel considered whether the bankruptcy court abused its discretion by remanding a case to state court. Prior to filing, a law firm brought an action against the debtor in state court, alleging breach of contract and account stated. The debtor filed a counterclaim, alleging the representation agreement between the debtor and the law firm was unenforceable and seeking recovery of fees paid to the law firm. Approximately one year later and after the law firm filed a motion for summary judgment, but before it was heard, the debtor filed a petition under chapter 13. Shortly after, the debtor removed the action to the bankruptcy court. The bankruptcy court required the parties to appear and show cause as to why the case should not be remanded to the state court. The bankruptcy court remanded the case.

The BAP explained that in evaluating whether to remand a case the bankruptcy court should use the same criteria as used to evaluate whether to abstain under 28 U.S.C. § 1334(c)(1). The BAP identified the twelve criteria as set forth in Stabler v. Beyers (In re Stabler), 418 B.R. 764, 769 (B.A.P. 8th Cir. 2009). The BAP also identified four additional factors as set forth in Sears v. Sears (In re Sears), 539 B.R. 368, 370 (D. Neb. 2015). The BAP explained that the bankruptcy court considered each of the sixteen required factors and no additional factors. The bankruptcy court found ten of the first twelve factors and three of the four additional factors favored remand. The debtor challenged the bankruptcy court's findings in connection with four of the first twelve factors.

The BAP found that the bankruptcy court may have committed error with one of those sixteen factors, but did not commit a "clear error of judgment" in weighing all of the factors, and therefore did not abuse its discretion.

STANDING

5. Wigley v. Wigley (In re Wigley), 886 F.3d 681 (8th Cir. Mar. 29, 2018) (Colloton, J.).

EIGHTH CIRCUIT: ALLEGED HARM BASED ON POTENTIAL LITIGATION DOES NOT CONFER "PERSON AGGRIEVED" BANKRUPTCY APPELLATE STANDING

In Wigley v. Wigley (In re Wigley), the Eighth Circuit Court of Appeals considered whether a non-party to a bankruptcy proceeding was a "person aggrieved" with standing to appeal certain bankruptcy court orders.

A creditor sued the debtor as guarantor in a pre-petition lease action. During the lease action, the debtor transferred some of his assets to the non-debtor. After obtaining judgment against the debtor in the lease action, the creditor filed a fraudulent transfer action against the debtor and non-debtor in state court. The state court found the debtor and non-debtor jointly and severally liable for $795,098, plus other fees. The debtor and non-debtor moved for amended findings. While the fraudulent transfer action was pending, the debtor filed a voluntary chapter 11 petition and proposed a plan that included a settlement of the pending fraudulent transfer action. The proposed settlement sought the estate's release of claims against the non-debtor in exchange for a $350,000 payment. The bankruptcy court denied confirmation, concluding that the proposed settlement was not fair and equitable as the settlement would release the non-debtor for a discounted payment and would harm the creditor. The court eventually confirmed a subsequent plan, which did not settle the fraudulent transfer action, and separately granted the creditor's motion for relief from stay so that the creditor could exercise its rights against the non-debtor in the fraudulent transfer action.

The non-debtor appealed the order denying confirmation, the order granting confirmation, and the order granting relief from stay to the Eighth Circuit Bankruptcy Appellate Panel, which dismissed her appeal for the lack of standing. On further appeal to the Eighth Circuit, the non-debtor argued that she was aggrieved by the order denying confirmation of the plan containing the settlement, contending that had the court confirmed the plan, upon payment of the settlement amount, she would have retained interests in the transferred assets and avoided further litigation. She further argued that the order confirming the plan and the order granting relief from the stay permitted further litigation against her.

On *de novo* review of standing, the Eighth Circuit affirmed the BAP's decision, explaining that only a "person aggrieved" has standing to appeal an order of the bankruptcy court. A party is a "person aggrieved" only if the party has been "directly and adversely affected pecuniarily" by the bankruptcy court order, such as when the order "diminishes the person's property, increases the person's burdens, or impairs the person's rights." The Eighth Circuit re-emphasized its statement in Opportunity Finance, LLC. v. Kelley, 822 F.3d 451, 458 (8th Cir. 2016), that generally, "a bankruptcy court order allowing litigation to proceed against an adversary defendant does not make that defendant a party aggrieved." The Eighth Circuit determined that the non-debtor's alleged harm based on potential litigation was too indirect to confer standing, that the orders merely disapproved a proposed settlement arising in the bankruptcy proceeding and simply maintained the status quo as to the non-debtor, and that the orders did not increase her burden of litigation or diminish her rights as any liability risk and litigation burden the non-debtor might face in the fraudulent transfer action pre-existed the bankruptcy proceeding. Therefore, she was not a "person aggrieved" by the orders and thus lacked standing to appeal.

PROCEDURE

6. Fulmer v. Fifth Third Equip. Fin. Co., et al. (In re Veg Liquidation, Inc.), 583 B.R. 203 (B.A.P. 8th Cir. Mar. 26, 2018) (Saladino, J.).

FINALITY OF SECTION 363 SALE ORDER BARS TRUSTEE'S CLAIMS

The Eighth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court's dismissal of a trustee's adversary proceeding, ruling that the finality of a 11 U.S.C. § 363 sale order, together with statutory provisions and rules, defeated the trustee's claims.

In converted chapter 11 to chapter 7 cases, the chapter 7 trustee filed an adversary proceeding against various parties more than two years after the bankruptcy court entered an order approving the sale of substantially all of the debtors' assets, claiming that the defendants concealed agreements and manipulated bids to take the assets for no value. The defendants countered, arguing that the trustee's action was an improper collateral attack on a final § 363 sale order. The bankruptcy court agreed with the defendants, applying the doctrine of *res judicata* and finality of the sale order to dismiss the trustee's claims.

On appeal to the BAP, the trustee argued that he was not subject to *res judicata*, asserting that he lacked privity with the parties to the sale order. The BAP disagreed, determining that the issue of privity was moot under the expansive, binding effect of a sale order under § 363(m), which protects good-faith purchasers as well as third parties who rely on the sale order from endless litigation.

The trustee also argued that the sale order was void because it resulted in non-consensual distributions violating the absolute priority rule under Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017). The BAP rejected the trustee's misplaced reliance on Jevic, noting that Jevic did not apply as Jevic was decided three years after issuance of the sale order, and that Jevic involved the timely appeal of a structured dismissal order, whereas the matter at bar did not arise from an appeal of the sale order. Additionally, the BAP determined that the finality bar of § 363(m) still applied as no appeal was taken and no stay of sale ever issued.

The BAP also rejected the trustee's arguments that unsupported, boilerplate findings in the sale order precluded application of § 363(m). To the contrary, the BAP determined that the bankruptcy did take in evidence, that the order was based on the entire record, and that no party appealed the findings of the sale order.

The BAP also denied relief from the sale order under Federal Rule of Civil Procedure 60, disposing of the trustee's due process concerns. The BAP further disposed of the trustee's various other allegations of fraud, collusion, or fraud on the court, concluding that such allegations were conclusory and failed to meet the level of plausibility required to survive dismissal under *Iqbal* and *Twombly* pleading standards. Last, the BAP refuted the trustee's request for leave to amend, agreeing with the bankruptcy court that the proposed amended complaint would not survive a motion to dismiss.

EXEMPTIONS

7. In re Jacklitch, No. 17-60624 (Bankr. D. Minn. Jul. 31, 2018) (Ridgway, J.).

EXEMPT LIFE INSURANCE PROCEEDS MAINTAIN EXEMPT STATUS WHEN DEPOSITED INTO AN IRA

The bankruptcy court held that exemptible life insurance proceeds maintained their exempt status, notwithstanding the fact that they were deposited into the debtor's IRA, where the trustee and debtor agreed that $34,000 in the IRA was traceable to such life insurance. In claiming the exemption, debtor relied upon two subdivisions of Minn. Stat. § 550.37, the state statute governing the exemption of life insurance proceeds: (1) subd. 10 states allows an exemption for "[a]ll money received by, or payable to, a surviving spouse or child from insurance payable at the death of a spouse, or parent, not exceeding $46,000"; and (2) subd. 20 provides that the exemption is not affected by the subsequent deposit of such funds in a bank or any other financial institution if the funds are traceable to their exempt source. The trustee objected because the insurance proceeds were deposited into an IRA as opposed to a checking or savings account. Its objection was based upon language in *Ross v. Simser* that "the tracing of an exemption of life insurance does not extend beyond its deposit into a checking or savings account at a financial institution." 258 N.W. 582 (Minn. 1935). In overruling the objection, the bankruptcy court examined the language of subdivision 20, which provides only that the exempt funds "traceable to their exempt source," may be subsequently deposited "in a bank or any other financial institution" and retain their exempt status—effectively holding that subdivision 20 altered the effect of *Ross*.

The trustee also objected to the debtor's claimed exemption under Minn. Stat. § 550.37, subdivision 24 because the debtor's right to receive payments from an IRA arguably is not on account of illness, disability, death, age or length of service pursuant to the holding in *In re Jenkins*, 300 B.R. 348 (Bankr. D. Minn. 2003). In overruling the objection, the court noted that a more recent decision by the Minnesota Supreme Court provided that IRAs are exempt property under subdivision 24 "as limited by the terms of subdivision 24(a) to an indexed present value and sums reasonably necessary for the support of the debtor and the debtor's spouse and children." *Clark v. Lindquist*, 683 N.W.2d 784, 788 (Minn. 2004). The court held, based on

Clark, that the debtor did not need to prove the "right to payment is on account of illness, disability, death, age or length of service," in order to claim such amounts exempt.

8. In re Thomas, No. 17-43661 (Bankr. D. Minn. Jul. 31, 2018) (Ridgway, J.).

HOMESTEAD SALES PROCEEDS DO NOT LOSE EXEMPT STATUS DURING PENDENCY OF BANKRUPTCY CASE.

Applying the "snapshot rule," the bankruptcy court held that homestead sale proceeds that are exempt on the petition date maintain their exempt status irrespective of whether the exemption expires post-petition. The debtor sold her homestead less than a year before filing her chapter 7 petition. In her schedules, the debtor exempted proceeds from the sale of her homestead in the amount of $51,860.00 under Minn. Stat. § 510.07, which provides an owner may sell or convey the homestead without subjecting it, or the proceeds of such sale for the period of one year after sale, to any judgment or debt.

The chapter 7 trustee objected to the exemption of homestead proceeds to the extent such proceeds remained in the debtor's possession one year after the sale of the home. The trustee argued that the plain language of Minn. Stat. § 510.07 must be interpreted to mean the exemption of proceeds lapses or expires one year after the sale. If proceeds remain one year after sale, such proceeds would be bankruptcy estate property.

The court overruled the trustee's objection and denied the motion—applying the "snapshot rule" to limit exemptions to the circumstances existing on the petition date. The court found that the proceeds exited the bankruptcy estate once exempted. In reaching its decision, the court also analyzed 11 U.S.C. § 522(c) which provides "property exempted under this section is not liable during or after the case for any debt of the debtor that arose…before the commencement of the case…"

AVOIDANCE

9. Merit Mgmt. Group, LP v. FTI Consulting, Inc., __ U.S. __, 138 S. Ct. 883 (February 27, 2018) (Sotomayor, J.).

SUPREME COURT LIMITS THE FINANCIAL SETTLEMENT SAFE HARBOR OF § 546(e)

The Supreme Court declared that the only relevant transfer for purposes of the trustee's avoidance powers "is the transfer that the trustee seeks to avoid." The fact that a transfer involves intermediate financial institutions does not implicate the financial settlement safe harbor of § 546(e) if the trustee seeks to avoid only the ultimate transfer between the non-financial-institutions.

The debtor had competed with another company for years for a harness racing license. Eventually, the debtor agreed to buy the other company and the other company withdrew its bid for the license. For the buy-out, the shareholders deposited their stock certificates into an escrow bank and the debtor deposited cash into a different escrow bank. The escrow banks distributed the assets after both sides fulfilled their contractual requirements.

After the debtor failed, it filed a bankruptcy petition. The bankruptcy court confirmed a chapter 11 plan and established a litigation trust. The trustee filed suit against the former shareholders of the acquired company arguing that the transfer was constructively fraudulent because the debtor was rendered insolvent and overpaid for the shares. The former shareholders sought judgment on the pleadings under Rule 12(c), contending that the transfer was a "settlement payment . . . made by or to (or for the benefit of)" a covered financial institution. § 546(e). The trial court granted the Rule 12(c) motion. The Court of Appeals reversed, finding that the escrow banks were "mere conduits."

Before the Supreme Court, the former shareholders argued that determining the applicability of the securities safe harbor in a multi-transaction transfer requires the reviewing court to consider the "component parts" of the transaction—i.e., not only the A →D "end-to-end" transfer, but the A →B →C →D transfers that included the two intermediary financial institutions. The trustee argued that only the A →D "overarching transfer" between debtor and the former shareholders mattered in the avoidance analysis.

Justice Sotomayor, writing for a unanimous Court, agreed with the trustee, but did not adopt the term "mere conduit." The Court relied on the plain language of § 546(e) and the statutory structure of the Code in holding that "the focus of the inquiry is the transfer that the trustee seeks to avoid." In short, § 546(e) is an exception to the trustee's avoidance powers ("[n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title . . . ."). Thus, the "starting point for the § 546(e) inquiry" is how the trustee seeks to employ the avoidance power to which the securities safe harbor provides an exception—i.e., "the transfer the trustee seeks to avoid."

The Court further held that the Code's structure—which frames the § 546(e) exception and the avoidance powers as "two sides of the same coin"—buttresses this interpretation, and also limits the scope of how a trustee may identify an avoidable transfer: "The trustee . . . must establish to the satisfaction of a court that the transfer it seeks to set aside meets the characteristics set out under the substantive avoidance provisions. Thus, the trustee is not free to define the transfer that it seeks to avoid in any way it chooses." A defendant may, of course, argue the trustee failed to identify a transfer within the Code's specific criteria; but if the court determines the trustee properly identified such a transfer "the court has no reason to examine the relevance of component parts when considering the limit to the avoiding power . . . ."

10. <u>O'Sullivan v CRP Holdings, A-1, LLC</u>, 2017 WL 4844244, No. 17-6012 (8th Cir. B.A.P. Sept. 22, 2017) (Schermer, J.).

BAP AFFIRMS BANKRUPTCY COURT DECISION THAT UNENFORCEABLE LIEN CAN BE AVOIDED UNDER § 522(f)

The Eighth Circuit Bankruptcy Appellate Panel came down strongly in favor of protecting a debtor's fresh start. It held that a creditor's docketed judgment created a judicial lien on the debtor's interest in his exempt homestead, even though such lien was not presently enforceable against the property under Missouri law; as such, the judicial lien could be avoided under 11 U.S.C. § 522(f). The debtor and his spouse owned their home in a tenancy by the entireties. Upon filing a petition for relief, the debtor claimed his interest in the home as exempt. Under Missouri law, docketing a judgment, which is against only one spouse, does not create a lien on property held in a tenancy by the entireties. Simply put, the creditor did not have a lien on the exempt property under the definition of "lien" provided by Missouri law. The BAP held that the Bankruptcy Code's definition of "judicial lien" is broader. The recording of the judgment created a cloud on the debtor's title and could potentially become a lien under Missouri law if the debtor's spouse died. That constituted a "charge against or interest in property," impaired the debtor's exemption, and therefore could be avoided under section 522(f).

11. <u>Cedar Rapids Lodge & Suites LLC et al. vs. John F. Seibert et al.</u>, No. 14-CV-04839, 2018 WL 747408 (D. Minn. Feb. 7, 2018) (Nelson, J.).

DISTRICT COURT UPHELD ASSIGNMENT OF § 544(B) CLAIMS IN BANKRUPTCY STIPULATION

Plaintiffs sued the debtor for fraud related to a Cedar Rapids hotel development in 2009; they obtained a judgement in 2012 (the "Iowa Judgment"). While the litigation was pending in Iowa state court, however, the debtor's net worth decreased by over $5.4 million and plaintiffs were unsuccessful in collecting the judgment. They responded by commencing a fraudulent transfer action in the U.S. District Court for the District of Minnesota against the debtor's wife, daughter and son-in-law (the "Fraudulent Transfer Litigation").

Faced with contempt proceedings in the Fraudulent Transfer Litigation, the debtor filed a chapter 7 bankruptcy petition. The bankruptcy trustee was substituted for the plaintiffs in the Fraudulent Transfer Litigation pursuant to § 544(b). Plaintiffs and the trustee entered into a stipulation pursuant to which the debtor's daughter and son-in-law paid $200,000 to the estate in exchange for releases. Plaintiffs received $100k, and the estate retained $100k of the proceeds. Under the stipulation, plaintiffs gave up any right to receive a distribution from the estate and the trustee assigned all remaining causes of action in the Fraudulent Transfer Litigation back to plaintiffs. No objections were filed and the stipulation was approved by the bankruptcy court in 2017.

In accordance with the stipulation, Plaintiffs were substituted back into the Fraudulent Transfer Litigation as plaintiffs, the claims against the debtor's daughter and son-in-law were dismissed but the claims against his wife went forward. Plaintiffs amended the complaint to name the debtor and several companies controlled by him as additional defendants. The complaint, as amended, alleges defendants engaged in an extensive pattern of actual and constructive fraudulent transfers. Defendants moved to dismiss on several grounds, including without limitation, that plaintiffs lacked standing because the trustee's assignment was invalid. More specifically, defendants argued: (1) a bankruptcy trustee cannot assign its "avoidance powers" under the Code; and (2) the claims set forth in the complaint were not property of the estate (and therefore cannot be assigned by the bankruptcy trustee). The district court considered and rejected both of defendants' theories.

In connection with defendants' first argument, the district court noted the distinction between avoidance powers created by the Code (e.g., § 547 or § 548), versus the trustee's power under § 544(b) "to step into the shoes of a creditor and bring claims under state law." Because the Fraudulent Transfer Litigation here is predicated on § 544(b) claims, and not powers of the trustee under the Code, the district court rejected defendants' theory that the stipulation was an impermissible assignment of the trustee's powers under the Code.

Second, the district court considered and rejected defendants' theory that the fraudulent transfer claims in this case were not property of the estate. The district court acknowledged the existence of a circuit split, but ultimately adopted the majority view that § 544(b) claims are property of the estate. The district court also noted that courts are divided as to whether a trustee may transfer avoidance claims. The court was persuaded by the fact that this case involved a transfer of pre-existing § 544b claims from the trustee back to creditors. The district court also noted that the Eighth Circuit has permitted creditors to pursue claims created by the Code upon a showing that the trustee cannot be relied upon to assert them, or that creditors can be granted derivative standing to pursue such claims when it is "necessary and beneficial to the fair and equitable resolution" of a bankruptcy case. Because an assignment "confers greater rights," however, the district court indicated that any assignment of § 544(b) claims must also be "necessary and beneficial" to the estate. The court reviewed the record below, including the trustee's statements in the motion to approve the stipulation, and decided that such standard was satisfied in this case because the stipulation reduced fees and burden to the estate, reduced the claims pool, and streamlined overall resolution of the case.

12. <u>Kelley v. McDonald (In re Petters Co., Inc.)</u>, Adv. No. 17-4107-KHS (Bankr. D. Minn. Jan. 17, 2018) (Sanberg, J.).
13. <u>Kelley v. Stapleton (In re Petters Co., Inc.)</u>, Adv. No. 17-4108-KHS (Bankr. D. Minn. Jan. 17, 2018) (Sanberg, J.).

AVOIDANCE OF INITIAL TRANSFER IS NOT PREREQUISITE TO RECOVERY FROM SUBSEQUENT TRANSFEREES

In companion cases, the bankruptcy court denied the defendants' motions to dismiss the trustee's fraudulent transfer actions, holding that 11 U.S.C. § 550 does not require actual avoidance of the initial transfer before a trustee can sue a subsequent transferee. Rather, the trustee need only allege that the initial transfer is avoidable.

In each case, the defendants were subsequent transferees. The trustee's suits to avoid the initial transfers were still pending. The subsequent transferees moved for dismissal under Federal Rule of Bankruptcy Procedure 7012(b)(6) for failure to state a claim, arguing that 11 U.S.C. § 550 implicitly requires that the initial transfer be actually avoided before the trustee can sue a subsequent transferee. The court denied the motions, holding that the trustee need only allege that an initial transfer is avoidable when suing a subsequent transferee to recover the value of the property transferred pursuant to 11 U.S.C. § 550(a).

The court acknowledged a split of authority, and sided with a majority of courts examining the legislative history of § 550 and applying a less restrictive interpretation of

§ 550(a). The court reasoned that the language, "to the extent that," as used in § 550 was intended to incorporate protections granted to transferees. So if an initial transferee has an avoidance defense, then a subsequent transferee may also raise that defense. Any amount granted under § 550(a) would be limited to the initial transfer amount, but the ability to avoid is not limited. The court further reasoned that to hold otherwise under a strict interpretation of § 550(a) would lead to an absurd, futile, and costly result in which the trustee would have to prepare and incur costs of filing the same complaint at a later time to assert the same causes of action.

14. Forster v Theis, 906 N.W.2d 846 (Minn. Ct. App. December 18, 2017) (Kirk, J.).

UNSECURED CREDITOR MAY PURSUE A FRAUDULENT TRANSFER CLAIM IN STATE COURT AFTER BANKRUPTCY CASE IS CLOSED

The Minnesota Court of Appeals held that the Minnesota state court had subject-matter jurisdiction to consider an unsecured creditor's fraudulent transfer action because the bankruptcy action was closed, and the bankruptcy trustee did not reopen the bankruptcy case to pursue the avoidance action.

Plaintiffs successfully objected to discharge of the debt owed to them by the debtors pursuant to 11 U.S.C. § 523(a)(4). During the plaintiffs' post judgment discovery, they uncovered several transfers made to insiders of the debtors. The plaintiffs filed a complaint in state court seeking to avoid the transfers, arguing the transfers were voidable under the Minnesota Uniform Fraudulent Transfer Act. The defendants challenged the state court's subject-matter jurisdiction and the plaintiffs' standing. The defendants argued that the bankruptcy court had exclusive jurisdiction and the bankruptcy trustee had exclusive standing to avoid the transfers at issue.

The Court of Appeals acknowledged that only a bankruptcy trustee may avoid fraudulent transfers under §§ 544 and 548 while a bankruptcy case is pending. In this case, however, the bankruptcy case was closed, and the bankruptcy trustee did not reopen it to seek avoidance of the transfers at issue. In reaching its decision, the court rejected the defendants' argument that the doctrine of equitable tolling preserves the bankruptcy trustee's exclusive standing to pursue the fraudulent transfer claim.

DISCHARGE & DISCHARGEABILITY

15. Lamar, Archer & Coffrin, LLP v. Appling, 138 S. Ct. 1752 (June 4, 2018) (Sotomayor, J.).

DEBTOR'S FALSE ORAL STATEMENT ABOUT A SINGLE ASSET DOES NOT PRECLUDE DISCHARGE OF DEBT WITHOUT A WRITING

The Supreme Court held that a debtor's statement about a single asset can be a "statement respecting the debtor's financial condition" under § 523(a)(2). However, when the "fraud" at issue is effectuated by such a statement, the *Appling* court noted that the statute "plainly heightens the bar to discharge" and § 523(a)(2)(B) requires that such statement be made in writing.

The debtor was a law firm client. Debtor and the law firm met in person to discuss his outstanding legal fees and whether they would continue to represent him in a civil lawsuit. In that context, debtor told his lawyer that he would soon receive a tax refund for $100,000 and the refund would be sufficient to pay his outstanding legal fees as well as all future legal fees. At the time debtor made the statement, however, he had already received the tax refund for a lesser amount and spent the entire amount on other business expenses. The law firm eventually sued and obtained a judgment against the debtor. Debtor filed a chapter 7 bankruptcy case and shortly after, the law firm commenced an adversary proceeding, objecting to discharge.

After trial, the bankruptcy court excepted the debt from discharge and found that the debtor had knowingly made two false representations upon which the law firm reasonably relied, causing the law firm to be damaged in the amount of its unpaid fees. The district court affirmed, but the 11th Circuit reversed. The *Appling* Court affirmed the 11th circuit, holding that the debtor's statement about his tax refund was a "statement respecting his financial condition," notwithstanding the fact that it was only one asset, and therefore, under § 523(a)(2)(B), the statement had to be made in writing for his debt to the law firm to be excepted from discharge.

16. Dahlin v. Lyondell Chem. Co., 881 F.3d 599 (8th Cir., January 26, 2018) (Benton, J.)

DISCHARGE OF A CREDITOR'S CLAIM CONTINGENT UPON ADEQUATE NOTICE

Plaintiff, a widow, sued her husband's former employer, alleging that his exposure to chemicals on the job from 1990 to 1995 caused him to develop a terminal form of cancer in 2012. The case went to trial and a jury awarded her damages in 2015. Defendant employer appealed, arguing its Chapter 11 plan of reorganization was confirmed in 2010 and discharged plaintiff's claim.

To be discharged in bankruptcy, due process requires that a claimant must have notice of the bankruptcy filing. What constitutes adequate notice turns on whether the creditor is "known" or "unknown" to the debtor. Known creditors must be provided with actual written notice of a debtor's bankruptcy filing and bar claims date. For unknown claimants, however, notice by publication is generally sufficient.

The appellate court explained that a "known" creditor is one whose identity is either known or "reasonably ascertainable" by the debtor. A creditor's identity is "reasonably ascertainable" if that creditor can be identified through "reasonably diligent efforts." The Eighth Circuit agreed with the district court that the debtor had conducted a reasonably diligent search for creditors inasmuch as it had hired an experienced bankruptcy consulting firm that reviewed all of the debtor's employee, vendor, accounts payable, and contract ledgers and identified over one million creditors. In this case, such a search did not reveal tort victims such as Plaintiff, and therefore, the Eighth Circuit held that Plaintiff was an "unknown" creditor and notice by publication was sufficient to afford due process. As a result, the judgment below was vacated.

17. U.S. Department of Labor v. Harris (In re Harris), --F.3d--, 2018 WL 3685766 (8th Cir. Aug. 3, 2018) (Smith, J.).

EIGHTH CIRCUIT AFFIRMS SUMMARY JUDGMENT EXCEPTING DEBT FROM DISCHARGE UNDER § 523(A)(4) BASED ON THE COLLATERAL EFFECT OF A PRE-PETITION ERISA ACTION

The debtor was the CEO, President, and Chairman of the Board of Directors of a company. Before he filed bankruptcy, the Department of Labor obtained judgment against him for breach of fiduciary duty under ERISA for failing to remit funds withheld from employee paychecks to the health insurance provider. Notably, the plan was 100% funded by employee contributions that were commingled in the company's general operating account after the funds were withheld.

After the debtor filed bankruptcy, the DOL filed a complaint under § 523(a)(4) "for fraud or defalcation while acting in a fiduciary capacity." The bankruptcy court determined that the collateral effect of the findings of fact in the pre-petition action satisfied the elements necessary to grant summary judgment in favor of the DOL, specifically (1) that a trust res existed because, under ERISA, employee contributions become plan assets when they are withheld from paychecks; (2) the debtor exercised control over the employee contributions commingled in the company's operating account; and (3) the debtor committed defalcation by directing the company to divert the employee contributions to pay corporate and personal expenses, including the debtor's personal home equity line of credit. The BAP affirmed.

The Eighth Circuit reviews grants of summary judgment *de novo*. On appeal, the debtor argued that he was not acting in a fiduciary capacity and that he lacked the intent required for defalcation. The Eighth Circuit cited its prior decisions for the propositions that a fiduciary relationship under § 523(a)(4) is a question of federal law, refers only to trustees of "express trusts," and does not include trustees of constructive trusts imposed after the fact because of the trustee's malfeasance. The debtor pointed to a line of cases holding that being a fiduciary under ERISA does not necessarily satisfy § 523(a)(4) and finding that an employer did not breach a fiduciary duty by simply failing to pay employee benefits. The Eighth Circuit, however, pointed out that all those cases involved employer contributions and not employee contributions. When only employ*er* contributions are involved, then personal liability arises only when the company fails to make the payment and the debtor is not a fiduciary until after the fact. When, on the other hand, the debtor exercises control over employ*ee* contributions before diverting the funds, then the fiduciary relationship preexists the liability and a fiduciary relationship exists under § 523(a)(4).

The debtor argued that he lacked the requisite intent because, among other things, he personally borrowed from his home equity line of credit to keep the company afloat, he directed the company not to pay him for several pay periods, he did not seek reimbursement of expenses, he believed the company was about to receive sufficient financing to pay all the premiums, and he believed that good checks had been sent to the insurer. The Eighth Circuit followed prior precedent that defalcation does not require actual knowledge of wrongdoing. Rather, the culpable state of mind may be found if the fiduciary consciously disregards or is willfully blind to a substantial and unjustifiable risk that his conduct will violate a fiduciary duty. The Eighth Circuit affirmed because the debtor did not dispute the finding of fact in the ERISA action that the debtor directed the company to make a payment on the debtor's personal home equity line of credit after determining that the company would be unable to make full payment to the health insurer.

18. Charles Gabus Motors, Inc. v. Tirrell (In re Tirrell), 572 B.R. 720 (B.A.P. 8th Cir. September 6, 2017) (Nail, J.).

BAP ENFORCED AGREEMENT AGAINST DEBTOR WHO STIPULATED TO FORGO DISCHARGE IF HE DEFAULTED UNDER A STIPULATION

The Eighth Circuit Bankruptcy Appellate Panel upheld the decision of the Bankruptcy Court denying the debtor a discharge of his debts in accordance with a default provision set forth in a court-approved stipulation.

The debtor entered into the stipulation with a creditor who had previously commenced an adversary proceeding seeking denial of the debtor's discharge under Section 727 of the Code. The debtor and creditor entered into a stipulation to resolve the adversary proceeding. Under the stipulation, debtor agreed to pay $45,000 in five installments in exchange for which the creditor agreed to dismiss the adversary proceeding. Under the stipulation, if the debtor failed to pay the installments on time, the creditor's remedy was to file an affidavit of default and ask the court to enter an order denying debtor a discharge. Notably, the stipulation did not include a "grace period" nor did it require creditor to deliver a notice to cure.

When the debtor failed to make the first payment due under the stipulation, the creditor promptly proceeded to enforce the stipulation. The debtor objected, making several arguments under state law in an attempt to prove the stipulation was an unenforceable contract. The debtor argued, for example, that he was only one day late to make the payment due to inclement weather, and therefore, the doctrine of impracticability excused his performance. The debtor also argued that the default provision was akin to an excessive liquidated damages clause and therefore void as a penalty under state law. The BAP reviewed the debtor's theories de novo and held that all of the debtor's contract-based defenses were inapplicable to the stipulation.

Moreover, the BAP unequivocally declined debtor's invitation to "soften" the default provisions of his stipulation. Notwithstanding any suggestion that the outcome was "harsh" to the debtor, the BAP made clear that the stipulation could be enforced against him in accordance with its original terms.

19. Piccinino v. U.S. Dep't of Educ. (In re Piccinino), 577 B.R. 560 (8th Cir. BAP December 7, 2017) (Shodeen, J.).

BAP APPLIES TOTALITY OF THE CIRCUMSTANCES TEST AND AFFIRMS DETERMINATION THAT SELF-IMPOSED HARDSHIP DOES NOT CONSTITUTE UNDUE HARDSHIP

The Eighth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court's finding that repayment of student loans would not constitute undue hardship because, among other reasons, the debtor’s underemployment was partly self-imposed and the debtor could afford income-based repayments of $0.00 per month.

Student loans can be discharged in bankruptcy only when repayment would constitute “undue hardship,” which is not defined by the Code. 11 U.S.C. § 523(a)(8). The burden of proof is on the debtor. In the Eighth Circuit, undue hardship is determined under a flexible “totality of the circumstances” test that mainly considers: (1) the debtor’s past, present, and reasonably reliable future financial resources; (2) a calculation of the debtor’s reasonably necessary living expenses; and (3) any other relevant facts and circumstances. Undue hardship is reviewed de novo.

(1) Past, Present, and Reasonably Reliable Future Financial Resources: the BAP found that the debtor’s underemployment was partly self-imposed. The debtor decided not to work for two years and offered no evidence she considered full-time employment after 2012. The debtor also failed to provide evidence for her argument that she was unable to find full-time employment that would pay enough for childcare. Importantly, childcare needs would naturally decrease as her child gets older. In light of the “evidence of her age, health, skill sets and abilities,” the debtor failed to meet her burden regarding future financial resources.

(2) Reasonably Necessary Living Expenses: the debtor’s schedules showed negative net monthly income based on monthly “rent” of $500 to her mother. However, the debtor paid rent to her mother only when she could. The BAP also found that the debtor’s pre-bankruptcy request for a loan modification reflected her belief she could make some level of payment.

(3) Other Relevant Facts and Circumstances: the debtor’s “employment decisions and her perception of future employment prospects reflect elements of self-imposed conditions which weigh against dischargeability;” the debtor was approved to participate in an Income Driven Repayment Plan with payments of $0.00 and she had sufficient funds to make those payments; and the debtor’s filing was for the admitted purpose of discharging her student loans constituting 98% of her total debt.

20. Dering Pierson Grp., LLC v. Kantos (In re Kantos), 579 B.R. 846 (B.A.P. 8th. Cir. January 9, 2018) (Dow, J.).

BAP: DEBTOR’S CONDUCT CONSTITUTED UNAUTHORIZED PRACTICE OF LAW, BUT DID NOT CONSITUTE A WILLFUL OR MALICIOUS INJURY UNDER § 523(a)(6)

The Eighth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court’s finding that the plaintiff-creditor failed to establish willfulness or maliciousness under 11 U.S.C. § 523(a)(6) where debtor wrongfully filed a mechanic’s lien against it. The Plaintiff contested the mechanic’s lien in Minnesota state court arguing unauthorized practice of law, fraud, and defamation. The state court entered judgment on the unauthorized practice of law count, but not on the fraud or defamation counts. Plaintiff commenced an adversary proceeding to determine that the debt owed by the debtor was excepted from discharge under 11 U.S.C. § 523(a)(6), on the basis that the debtor’s conduct giving rise to the debt was “willful” and “malicious.”

The BAP followed the Supreme Court's previous guidance that "willful" for purposes of § 523(a)(6) "requires a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury," or, in other words, an intentional tort. The BAP also followed the Eighth Circuit's guidance that "malice" means that the actions were "targeted at the creditor . . . at least in the sense that the conduct is certain or almost certain to cause financial harm."

At trial, the debtor testified that he did not have firsthand knowledge related to the mechanic's lien, but explained that he believed he had the authority to sign the mechanic's lien based on information provided by the subcontractor. Further, the debtor testified that he only intended to preserve the subcontractor's secured position, as he had regularly done for many years, and that he did not intend to cause injury to any party. Based on these facts, the bankruptcy court found that the plaintiff failed to carry its burden of proving willfulness and maliciousness under the statute.

The BAP found that the bankruptcy court's determination that plaintiff failed to meet its burden was not clearly erroneous. Instead, the BAP found that the evidentiary record supported a finding that the debtor had no intent to cause an injury, particularly because upon learning that the facts stated in the mechanic's lien were not true the debtor immediately filed a release of the lien. Finally, the BAP ruled that plaintiff failed to identify any finding that was in error and rejected plaintiff's argument that the unadjudicated defamation claim necessarily entitled it to judgment under § 523(a)(6).

21. Velde v. Thiel (In re Thiel), 587 B.R. 92 (B.A.P. 8th Cir. July 26, 2018) (Nail, J.); affirming Velde v. Thiel (In re Thiel), Adv. No. 17-06007 (Bankr. D. Minn. January 23, 2018) (Ridgway, J.).

BANKRUPTCY COURT REVOKES DISCHARGE FOR KNOWING AND FRAUDULENT FAILURE TO SURRENDER TAX REFUNDS

The Eighth Circuit Bankruptcy Appellate Panel affirmed the revocation of a chapter 7 debtor's discharge, pursuant to 11 U.S.C. § 727(d)(2), for knowingly and fraudulently failing to surrender to the chapter 7 trustee tax refunds for pre-petition wages that were received post-petition. Initially, the trustee filed a motion under § 542(a) for turnover of the tax refunds, but the debtor had spent all of the refunds. The bankruptcy court denied the turnover motion, as a condition to turnover is the possession, custody, or control of the property being sought.

The trustee then commenced an adversary proceeding seeking revocation of the debtor's discharge pursuant to § 727(d)(2). The bankruptcy court, taking into account the debtor's pattern of conduct and inconsistent statements, determined that the debtor lacked credibility and found that the debtor knowingly and fraudulently failed to surrender the income tax refunds to the trustee. The bankruptcy court entered an order revoking the debtor's discharge.

The BAP reviewed for clear error the bankruptcy court's finding that the debtor acted "knowingly and fraudulently." Reviewing the record, the BAP determined that the bankruptcy court's finding was permissible and not clearly erroneous. Judgment was affirmed.

22. Snyder v. Dykes (In re Dykes), Adv. No. 17-4022 (Bankr. D. Minn. Feb. 26, 2018) (Sanberg, J.).

FAILURE TO MAINTAIN RECORDS FOR HUNDREDS OF THOUSANDS OF DOLLARS OF TIMEPIECES AND KNOWING FAILURE TO DISCLOSE TRANSFERS FOR THE BENEFIT OF THE DEBTORS' CHILDREN RESULTS IN DENIAL OF DISCHARGE UNDER § 727

The bankruptcy court denied the debtors' discharge because the debtors failed to maintain records related to purchasing, selling, and trading valuable, collectable watches; could not account for the disposition of at least four of those watches valued at over $145,000; and knowingly failed to disclose transfers made for the benefit of the debtors' children.

The debtors filed a statement of financial affairs ("SOFA") that failed to disclose transfers for the benefit of the debtors' children made within the year prior to filing totaling $108,473.77. When the U.S. Trustee began investigating the debtors' financial affairs, the debtors amended the SOFA to include the transfers. At trial, the debtors testified that they had routinely paid their children's college expenses, felt it was their obligation to do so, and that their children's financial aid was based on the parent's income.

Also, the debtor, an avid watch collector, lacked documentation to support purchases, sales, or other disposition of at least 22 watches ranging in value from $4,350 to $107,000 per watch. The debtor testified that he didn't always receive or maintain the paperwork for his collectable watches. The court did not find his testimony credible because a sophisticated collector like the debtor, and a reputable jeweler, could be expected to exchange and maintain the paperwork necessary to substantiate a collection of such valuable timepieces. The Court further found that at least some of the paperwork was in a storage unit for which the debtors stopped making payments, and the storage unit company disposed of all of the units' contents, including some of the watch documentation.

The court rejected the U.S. Trustee's argument that discharge should be denied pursuant to § 727(a)(2)(A) because the U.S. Trustee failed to prove the requisite intent to hinder, delay, or defraud creditors through the transfer of property. The Court denied the debtors discharge, however, on three separate grounds: (1) under § 727(a)(3), the debtors failed to justify their lack of records for the watch collection, making it impossible to ascertain the debtors' true financial condition; (2) under § 727(a)(5), the debtors failed to satisfactorily explain what happened to four missing watches with a retail value of at least $145,000 and failed to account for assets lost when the debtors' storage units were emptied; and (3) under § 727(a)(4)(A), the debtors initial SOFA, which omitted $108,473.77 of transfers in the year preceding filing of the petition and omitted a ¾ carat loose diamond in the debtors' possession, was a false statement made with reckless indifference to the truth and therefore a knowingly false statement.

PLANS, DISMISSAL & CONVERSION

23. U.S. Bank Nat'l Assoc., Trustee, by and through CWCapital Asset Mgmt LLC v The Village at Lakeridge, LLC, 138 S.Ct. 960 (March 5, 2018) (Kagan, J.).

SUPREME COURT: THE STANDARD FOR NON-STATUTORY INSIDER STATUS IS CLEAR ERROR UNDER NINTH CIRCUIT TEST, BUT THE TEST MAY BE WRONG

The Supreme Court declared that the standard of review for a determination of non-statutory insider status under the Ninth Circuit’s “arm’s length” test is clear error. The Justices explicitly declined to endorse the Ninth Circuit's test.

The debtor owed $10 mm to a bank and $2.76 mm to an entity that owned 100% of the debtor. In its chapter 11 plan of reorganization, the debtor placed each creditor in a separate class and proposed to impair both claims. The bank voted against the plan. The owner’s vote did not count for purposes of cramdown under § 1129(a)(10) because the owner was an insider under § 101(31)(B)(iii), which provides a non-exhaustive list of insiders.

The owner then sold its $2.76 mm claim for $5,000.00 to a man who was in a romantic relationship with an officer and director of the owner. The claim purchaser voted in favor of the plan. The bank objected that the claim purchaser was also an insider because of his romantic relationship and because the transaction was not at arm’s length. The lower courts all applied the Ninth Circuit test, under which a creditor is a non-statutory insider if two conditions are met: (1) the creditor’s relationship with the debtor is comparable to that of the insiders listed in the statute; and (2) the relevant transaction is negotiated at less than arm’s length.

The bankruptcy court held that the transaction was conducted at arm’s length based on its findings that the claim purchaser viewed the claim as a “speculative investment” and did adequate due diligence. Therefore, the bankruptcy court held that the bank failed to prove the second prong of the test. The Ninth Circuit held that whether the transaction was at arm’s length is primarily a factual question and therefore entitled to clear error review. Under this deferential standard, the Ninth Circuit affirmed.

Justice Kagan, writing for a unanimous Court, rejected the bank’s argument that application of the test used in the Ninth Circuit requires development of legal principles such that the issue should be reviewed de novo. Instead, the Court held that there is a near-universal understanding that “arm’s length” means the transaction was conducted as though the parties were strangers. Because this determination is fact intensive, the Court affirmed the use of a clear-error standard of review. The Court explicitly noted that it declined to address the question of whether the Ninth Circuit's test is correct.

Justices Kennedy and Sotomayor filed separate concurrences to clarify that the “Court’s holding should not be read as indicating that the non-statutory insider test as formulated by the [Ninth Circuit] is the proper or complete standard to use in determining insider status.” Justice Kennedy specifically asked whether the test should include an inquiry as to whether the same deal could and should have been offered to other parties who might pay a higher price.

While declining to address whether the Ninth Circuit’s test is correct, Justice Sotomayor (joined by Kennedy, Thomas, and Gorsuch, JJ) pointed out that a statutory insider is presumed to be incapable of conducting a transaction at arm’s length and cannot vote in favor of a plan under any circumstances. Consequently, applying an “arm’s length” test for non-statutory insiders results in disparate treatment of similar individuals. Significantly, Justice Sotomayor noted that the standard of review may be different with a different test.

For now, non-statutory insider status is to be reviewed for clear error if the legal test involves a determination of whether the transaction was conducted at arm’s length, but the test may be up for debate.

24. The Paddock, LLC v. Bennett (In re Bennett), 584 B.R. 15 (8th Cir. B.A.P. April 19, 2018) (Shodeen, J.).

REVIEWING FOR CLEAR ERROR, BAP AFFIRMS BANKRUPTCY COURT DECISION THAT MANUFACTURED HOME IS PERSONAL PROPERTY UNDER IOWA LAW

The Eighth Circuit Bankruptcy Appellate Panel analyzed Iowa state law regarding fixtures and concluded that the debtors’ manufactured home was personal property, rather than real property. As a result, the debtors were able to confirm a chapter 13 plan that treated an installment sale contract, secured by their manufactured home, as partially secured and partially unsecured. The lender argued that such treatment was prohibited by 11 U.S.C. § 1322(b)(2), which provides that a chapter 13 plan may not modify the rights of a holder of a secured claim secured by a security interest in real property that is the debtor’s principal residence. After an evidentiary hearing, the bankruptcy court determined that the manufactured home was not a fixture, and therefore not real property. The correct legal standard under Iowa law was not in dispute, but the lender challenged the bankruptcy court’s findings and its application of the legal standard. In particular, the lender challenged the bankruptcy court’s finding that the lender did not intend to make the manufactured home a fixture. The lender also leased the underlying real property to the debtors. Despite language in the lease that the home would be “installed as a permanent improvement and fixture,” the bankruptcy court found that the home was not actually installed on a permanent foundation, it was capable of being moved, the lease could be terminated on 60 days’ notice, and the debtors would have been permitted to remove the home under some circumstances. Perhaps the most interesting aspect of the decision is the level of deference given by the BAP to the bankruptcy court’s determination that the manufactured home was not a fixture under Iowa law. The BAP, noting that mixed questions of law and fact “are not all alike,” reviewed the decision for clear error due to the centrality of case-specific factual issues.

25. In re The Archdiocese of Saint Paul and Minneapolis, 579 B.R. 188 (Bankr. D. Minn. 2017) (Kressel, J.).
26. In re The Archdiocese of Saint Paul and Minneapolis, 579 B.R. 821 (Bankr. D. Minn. 2017) (Kressel, J.).
27. In re The Archdiocese of Saint Paul and Minneapolis, 579 B.R. 823 (Bankr. D. Minn. 2017) (Kressel, J.).

COURT DENIES CONFIRMATION OF COMPETING PLANS PROPOSED BY DEBTOR AND CREDITORS COMMITTEE: (1) HOLDING PROPERTY OF NON-DEBTORS

CANNOT BE USED TO FUND A PLAN WITHOUT THEIR CONSENT; AND (2) ESTABLISHING A TEST FOR RELEASES OF NON-DEBTOR THIRD PARTIES

In two orders and a joint memorandum, the bankruptcy court denied confirmation of competing plans proposed by the committee of unsecured creditors and the debtor. In the process, the court directed the parties to return to mediation, decided whether liability insurance proceeds and parish contributions belong to the bankruptcy estate, decided whether indemnity claims can be disallowed or discharged, and established criteria for confirming a plan that provides for discharge of claims against non-debtor third parties, among other issues.

In the joint memorandum, the court took notice of the intense impact of this case on people in light of hundreds of proofs of claim describing sexual abuse by priests and costs that will fall on current employees, students at Catholic schools, parishioners, and other innocent persons. The court also questioned whether a one third contingency fee is appropriate for completing proofs of claim. Most significantly, the court reminded the parties that a resolution will require agreement between all constituencies.

The Committee's Proposed Plan

The court sustained objections based on failure to provide for all claims in the committee's proposed plan, including mortgages secured by real estate owned by the debtor for loans taken out by two Catholic high schools. The court held that a security interest qualifies as a claim that must be provided for by the plan even if the debtor is not personally liable. Also, the proposed plan failed to provide for indemnification and contribution claims by the parishes. The proposed plan provided that contingent contribution claims would be disallowed pursuant to 11 U.S.C. § 502(e)(1)(B), but the committee did not formally object to the claims. Because § 502(a) states that a claim is deemed allowed unless an interested party objects, the contingent contribution claims were allowed and must be provided for in a confirmable plan.

For similar reasons, the court sustained objections that the proposed plan improperly designated various claims, including claims for support and maintenance of inactive and active credibly accused priests, as unimpaired based on a proposal to disclaim the liability under civil law.

The court sustained the parishes' objections that the plan cannot transfer insurance proceeds to a trust without the consent of the parishes because Minnesota law restricts an insurer's ability to transfer or release a policy if there are known claims against the insured that would remain unsatisfied due to the insured's financial condition. For similar reasons, the court sustained objections that the proposed plan violated Minnesota law because it would transfer interests in worker's comp and medical insurance proceeds to the trust.

The court also held that the insurance proceeds could not be transferred without the consent of other constituents with interests in the proceeds. For example, the proceeds may belong to officers and directors if they are the named insureds and the policies are meant to protect the officers and directors from claims made against them personally. Even if the policies and proceeds belong to the estate, anti-assignment clauses may prevent assigning insurance proceeds to a trust absent the insurer's consent. And, the debtor may hold bare legal title for the benefit of a non-debtor, including possible tort claimants.

The court also sustained feasibility objections without an evidentiary hearing even though feasibility is typically a fact issue. Because the committee's proposed plan would require the debtor to obtain financing to fund the plan, but failed to demonstrate that obtaining financing was likely, the plan was unfeasible on its face. In addition, the plan was unfeasible because it depended on proceeds from future litigation, which is speculative and uncertain. Finally, the plan was unfeasible because it relied on fundraising, which is speculative and may be hampered by the unwillingness of charitable donors to pay off judgment or tort creditors.

The court sustained objections to the committee's proposal to fund the plan partly from increased parish assessments because the debtor cannot be legally compelled to levy assessments against the parishes and the parishes cannot be legally compelled to pay assessments.

The court sustained objections of unfair discrimination between pending and future tort claimants, but overruled objections of unfair discrimination between holders of guaranties and between holders of claims for contribution and indemnification. Because the plan did not provide a basis for discriminating between pending and future tort claimants, the court held that the proposed plan failed to satisfy the four-part test: (1) whether the discrimination is supported by a reasonable basis; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) the treatment of the classes discriminated against. On the other hand, because contingent indemnification claims may be disallowed under § 502(e), disparate treatment between holders of indemnification claims and holders of guaranty claims is not unfair discrimination.

The court overruled objections that the proposed plan called for advisory opinions regarding the legality of using insurance proceeds to fund the plan, among other issues. To the contrary, the court held that an objection to plan confirmation is a case or controversy that requires resolution of the issues as part of the plan confirmation process.

Because the proposed plan would likely result in extended litigation about more than a dozen issues, the court held that it would unnecessarily prolong the bankruptcy case and waste estate resources.

Finally, the court held that the committee's proposed plan failed to provide adequate means for its implementation, as required by § 1123(a)(5), because of the speculative sources of funding and reliance on proceeds from future litigation.

The Debtor's Proposed Plan

The court sustained an objection that the debtor's proposed plan failed to provide for claims for medical expenses, lost wages, or other damage claims that may be asserted by trustees for deceased tort claimants. The court next repeated its analysis of issues that also applied to the committee's proposed plan.

Significantly, the court considered what appears to be an issue of first impression in the Eighth Circuit: whether the proposed plan improperly purported to release claims against non-debtor third parties. The court surveyed the case law nationally, including divergent views among ten different Circuit Courts of Appeals. Based on the law in other jurisdictions, the court formulated four criteria: (1) large or numerous liabilities against the debtor and the co-liable parties to be released, (2) a substantial contribution from the non-debtor co-liable parties, (3) the importance of the third party releases to the reorganization process, and (4) significant acceptance of the plan by the group of creditors who are being asked to give up their claims against the non-debtor co-liable parties. The court sustained the objection based on the number of tort-claimants who had rejected the plan.

Finally, the court over-ruled objections that the plan was proposed in bad faith because mere disagreements between the debtor and the committee do not equate bad faith.

PROPERTY OF THE ESTATE

28. The Official Committee of Unsecured Creditors v. The Archdiocese of St. Paul and Minneapolis, et al. (In re The Archdiocese of St. Paul and Minneapolis), 888 F.3d 944 (8th Cir. April 26, 2018) (Melloy, J.).

EIGHTH CIRCUIT: BANKRUPTCY COURT CANNOT SUBSTANTIVELY CONSOLIDATE DEBTOR WITH NON-DEBTOR NON-PROFIT ENTITIES

The Eighth Circuit Court of Appeals affirmed denial of the Creditors' Committee's motion seeking substantive consolidation of more than 200 affiliated non-profit non-debtor entities with the debtor because, among other reasons, substantive consolidation would have required the commencement of involuntary bankruptcy proceedings.

The Committee, representing more than 400 clergy sexual abuse victims, argued that the non-debtor entities should be consolidated because they were directly controlled and supervised "in all material aspects" by the debtor, including "the oversight of financial and property-related decision-making." Consolidation would have allowed the Committee to combine the debtor's and the non-debtor entities' assets to satisfy creditors. The Committee's asserted legal basis for substantive consolidation was 11 U.S.C. § 105(a), which gives bankruptcy courts the power to "carry out the provisions of the Bankruptcy Code." The Eighth Circuit noted that it has previously recognized the bankruptcy courts' authority to substantively consolidate debtor entities, as have other circuit courts, though it is an "extraordinary remedy." It continued, however, to point out that only the Ninth Circuit has ever permitted substantive consolidation of debtor and non-debtor entities. Further, it emphasized that no court has ever consolidated a debtor and a non-profit non-debtor entity, "let alone a debtor and over 200 non-profit non-debtors."

The Eighth Circuit then examined § 303(a)'s prohibition of involuntary bankruptcy proceedings involving non-profit entities. The court found that permitting the involuntary proceeding for the non-debtor entities under § 105(a) would be in direct contravention of § 303 of the Bankruptcy Code, precluding such relief. The court affirmed the denial of the Committee's motion for substantive consolidation.

FEES

29. McCormick v Starion Financial (In re McCormick), 894 F.3d 953 (8th Cir. July 3, 2018) (Beam, J.).

EIGHTH CIRCUIT AFFIRMS BANKRUPTCY COURT'S DECISION TO REDUCE FEES AND EXPENSES

Starion Financial objected to confirmation of the debtors' chapter 11 plan of reorganization because the plan failed to provide for Starion's attorney fees and Starion was an over-secured creditor pursuant to § 506(b). The objection was resolved through a plan addendum that provided for payment of Starion's fees and required Starion to submit an itemized statement "[a]t least ten days prior to the Effective Date of the Plan." Starion submitted the itemized statement a few days after the deadline. The debtors refused to pay the fees, arguing: (1) there was no agreement for payment of fees; (2) the statement was untimely; and (3) the fees were not reasonable. The bankruptcy court ruled in favor of the debtors partly because Starion's over-secured status arose from judgment liens that did not provide for fees. The BAP reversed because the underlying loan agreements provided for fees. The BAP noted that over-secured status did not have to be related to the agreement to pay fees and the BAP remanded for determinations of timeliness and reasonableness. Upon remand the bankruptcy court determined that untimeliness of two days was not a material breach and reduced the fees from approximately $125,000 down to approximately $83,000. The debtors appealed again and the BAP affirmed.

Before the Eighth Circuit, the debtors argued that the judgment liens were not consensual and therefore could not constitute an "agreement" under § 506(b), relying on In re Gledhill, 164 F.3d 1338, 1340-42 (10th Cir. 1999). The Eighth Circuit, however, pointed out that the debtors agreed to pay Starion's fees not only in the original loan documents, but also in the plan addendum. Furthermore, the judgment liens were the result of the debtors defaulting on a workout agreement that provided for confessions of judgments and additional collateral. The Eighth Circuit found that the judgment liens "were always part of the secured claim between Starion and the McCormicks, and came into being because Starion attempted to work with the debtors to collect on its secured debt." The Eighth Circuit rejected the debtors' argument that the original loan documents had "merged" into judgments that did not allow for fees. The Eighth Circuit, however, noted that the lien documents did not provide for fees only because the North Dakota judgment lien statute does not allow for fees. Noting that the North Dakota statute does not govern in a federal bankruptcy case, the Eighth Circuit held that the allowed secured claim was based on the "entirety of the dealings" between Starion and the debtors, and not limited by the judgment liens.

Finally, the debtors argued that the bankruptcy court erred in relying on Restatement (Second) of Contracts § 241 to determine that the late submission of the itemized statement was not material because there was no prejudice, the breach was cured almost immediately, and Starion was not guilty of unfair dealing by submitting the statement a few days late. The debtors argued that instead of looking at § 241, that the court should have analyzed whether time was of the essence. The Eighth Circuit found that the bankruptcy court did not err in finding that the breach was not material and the fee application was properly allowed.

CLAIMS

30. United States v. Austin (In re Austin), 583 B.R. 480 (B.A.P. 8th Cir. Apr. 9, 2018) (Sanberg, J.).

OBJECTING PARTY BEARS BURDEN TO PRODUCE “SUBSTANTIAL EVIDENCE” THAT IS OBJECTIVE AND SUFFICIENT TO OVERCOME PRIMA FACIE VALIDITY OF SECURED CREDITOR’S PROOF OF CLAIM AND ASSERTED VALUATION

On *de novo* review, the Eighth Circuit Bankruptcy Appellate Panel reversed the bankruptcy court and held that the debtors did not present “substantial evidence” sufficient to overcome the prima facie validity of a secured creditor’s proof of claim and asserted valuation.

In their chapter 13 case, the debtors scheduled two contingent and unliquidated worker’s compensation claims, assigning $0.00 or “unknown value” to them. The IRS filed a proof of claim, asserting in part a secured claim from a tax lien. About seven months later, the debtors settled their worker’s compensation claims for a net amount of $15,661.60. The IRS then amended its proof of claim, asserting a secured claim in the amount of $15,661.60—the net amount of the settlement of the worker’s compensation claims.

The debtors objected to the claim as to the value of the IRS lien against the worker’s compensation claims proceeds. In support of their objection, the debtors presented an affidavit from their workers’ compensation attorney, who opined that the worker’s compensation claims had a “nuisance” value of $3,000.00 as of the petition date, and that his post-petition work increased the value. The IRS responded, arguing that the affidavit was not substantial evidence sufficient to rebut the prima facie validity of the IRS’s proof of claim, and that the value attributable to the worker’s compensation claims should be the settlement amount.

After hearing the contested claim objection without taking evidence or hearing testimony, and without providing the IRS the opportunity to cross-examine the affiant, the bankruptcy court took the matter under submission. The bankruptcy court sustained the debtors’ objection, ruling that the affidavit constituted “substantial evidence” of the value of the worker’s compensation claims sufficient to overcome the prima facie validity of the IRS’s claim, and valued the worker’s compensation claims at $3,000.00.

The IRS appealed, arguing that the bankruptcy court erred in determining that the debtors presented sufficient substantial evidence to rebut the prima facie validity of the IRS claim since the sole affidavit in support of the objection contained uncorroborated and hearsay statements, and that the IRS did not have the opportunity to cross-examine the affiant. On appeal, the debtors argued that the IRS did not preserve the sufficiency of evidence issue and therefore waived that argument. On *de novo* review, the BAP initially determined that the IRS’s sufficiency of evidence issue was not waived as the IRS raised the issue several times during the claim objection hearing.

The BAP went on to hold that the debtors failed to meet their burden of producing substantial evidence “that has a reasonable, objective basis for the valuation” of the worker’s compensation claims, sufficient to rebut the IRS’s presumptively valid proof of claim.

The BAP noted that the affidavit was the affiant’s personal opinion of value, and that the affidavit contained no financial or factual information necessary to support the opinion. There was nothing in the affidavit that explained what the affiant did to increase the value of the worker's compensation claims. The worker's compensation claims were for injuries sustained in employment. The affiant's work would have had no effect on the value of the extent of the injuries; the affiant's efforts simply uncovered facts, which aided in recovery. The affiant provided no documentation to corroborate the claims' valuation of $3,000.00 as of the petition date, when the claims settled for over $21,000.00 around seven months later. The affiant could have presented copies of the filed workers compensation claims, evidence of the statutory scheme for valuing such claims, or evidence of past awards for similar claims. Further, the IRS had no opportunity to cross-examine the affiant, as no evidentiary hearing was held, no testimony was taken, and no evidence was admitted.

The BAP reasoned that "[a]llowing a valuation of a tort claim without a reasonable factual basis encourages abuse. Debtors could avoid a secured creditor's interest in tort claims simply by failing to obtain the facts necessary to support those claims."

31. In re Wigley, No. 16-43707-WJF (Bankr. D. Minn. Feb. 9, 2018) (Fisher, J.). DEBTOR'S OWN LIABILITY WAS NOT EXTINGUISHED AS RESULT OF SATISFACTION OF REDUCED CLAIM AND SUBSEQUENT DISCHARGE IN CO-DEBTOR'S CASE; LANDLORD'S CLAIM FOR LEASE TERMINATION DAMAGES CAN BE LIMITED EVEN IF CLAIM LIABILITY DERIVES FROM FRAUDULENT TRANSFER JUDGMENT

The bankruptcy court overruled the debtor's objection to claim in part and allowed the claim in part, holding, among other things, that the debtor's own liability was not extinguished as a result of the satisfaction of a reduced claim and subsequent discharge in a co-debtor's case pursuant to 11 U.S.C. § 524(e), which preserves the liability of a co-debtor on discharged debt, and that 11 U.S.C. § 502(b)(6)'s limit on lease termination damages also limits a fraudulent transfer claim that is derivative of a lease termination claim.

The landlord obtained both a pre-petition judgment against a co-debtor in a lease action and a pre-petition judgment against the debtor and co-debtor in a Minnesota Uniform Fraudulent Transfer Act ("MUFTA") action. Later, in the co-debtor's chapter 11 bankruptcy case, the court reduced the amount of the landlord's claim under § 502(b)(6). The co-debtor paid off the reduced claim and received a discharge. Later, in the debtor's own chapter 11 case, the landlord filed a claim for the full amount of the fraudulent transfer judgment plus interest. The debtor objected to the claim arguing, among other things, that the claim should be disallowed because it was satisfied and discharged in the co-debtor's case, that § 502(b)(6) should limit any claim against the debtor, and that the landlord had failed to mitigate damages.

First, the court determined that pursuant to 11 U.S.C. § 524(e), which provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any entity for, such debt," the satisfaction and discharge of the claim reduced under 11 U.S.C. § 502(b)(6) in the co-debtor's case did not preclude any claim by the landlord in the debtor's case.

Next, the court agreed with the debtor that the statutory lease termination damages cap in § 502(b)(6) applied to limit the landlord's claim against the debtor. The landlord had argued that § 502(b)(6) did not apply because the claim was based on fraudulent transfer rather than lease termination. The court ruled that the claim, although based on fraudulent transfer, derived from a preexisting debtor-creditor relationship by a judgment for lease termination, and therefore § 502(b)(6) applied to limit the claim. In its ruling, the court relied on Eighth Circuit case law providing that MUFTA "is not substantive in nature, but instead merely confers an alternate remedy for protecting preexisting creditor rights," relied on cases characterizing MUFTA liability as derivative, and reasoned that the fraudulent transfer judgment was dependent on lease termination and the judgment arising from that termination. The court dismissed the landlord's preclusion arguments because the issue of whether 11 U.S.C. § 502(b)(6) applied was unavailable during pendency of the state court fraudulent transfer action as the debtor had not yet filed bankruptcy.

Finally, the court held that collateral estoppel and the Rooker-Feldman doctrine prevented the court from considering the debtor's mitigation of damages issue. Collateral estoppel precluded consideration because the issue had already been raised and decided in a state court proceeding in which the debtor and the landlord was a litigant where both had the opportunity to litigate. The Rooker-Feldman doctrine precluded consideration because the bankruptcy court's consideration of the issue would invite review of the state court order denying vacation of the fraudulent transfer judgment.

MISCELLANEOUS: ATTORNEY DISCIPLINE

32. Briggs v. Reed, 888 F.3d 930 (8th Cir. April 25, 2018) (Benton, J.).

EIGHTH CIRCUIT AFFIRMS SUSPENSION FROM PRACTICING IN BANKRUPTCY COURT BECAUSE ATTORNEY FAILED TO COMPLY WITH COURT ORDERS

The Eighth Circuit Court of Appeals affirmed the district court's judgment affirming the bankruptcy court's order sanctioning the appellant, an attorney, for contempt of an order compelling turnover and for misleading the court. The Appellate Court likewise affirmed a ruling that appellant's request for reinstatement to practice before the bankruptcy court was properly denied.

Appellant had agreed to represent approximately 100 clients of another attorney who had been suspended from practicing law in the bankruptcy court for the eastern district of Missouri. In connection with an order to show cause on the disgorgement of the former attorney's fees, the trustees were ordered to provide the court with specific information about the fees. The trustees sent appellant demands for documents and information and later moved to compel the turnover of documents to comply with the court's order to show cause. The bankruptcy court then ordered turnover and subsequently sanctioned appellant for failure to comply with the turnover order and for deliberately and with deceptive intent making misleading representations to the court, relying, in part, on appellant's prior disciplinary records. The sanctions order allowed appellant to move for reinstatement. Appellant requested reinstatement from the chief bankruptcy judge and, when that request was denied, from the chief district court judge.

The Eighth Circuit rejected appellant's argument that the sanctions order was unconstitutional under *Stern v. Marshall*, 564 U.S. 462 (2011). The court also rejected appellant's argument that the record did not support a contempt finding for failure to comply with the turnover order because appellant was ordered to seek documents from third parties and the bankruptcy court's contempt order adequately established that Appellant had failed to adequately do so. Relying on *Schlaifer Nance & Co. v. Estate of Warhol*, 194 F.3d 323, 335 (2d Cir. 1999), the Eighth Circuit determined that the bankruptcy court erred in sanctioning appellant for deliberately misleading the court because the bankruptcy court based that conclusion on disputed questions of fact without holding an evidentiary hearing. However, because the bankruptcy court had two independent bases for the sanctions order, remand was not compelled. The Eighth Circuit also rejected appellant's argument that the request for reinstatement to practice was improperly denied because appellant had not made the request to the bankruptcy judge who issued the order of suspension; neither the chief bankruptcy judge nor the chief district court judge were permitted to resolve appellant's request. Rather, appellants remedy was to make the request by motion directly to the bankruptcy judge and subsequently appeal if the motion for reinstatement were denied.

Roses and Thorns with the Trustees

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Barnesville

Nauni Jo Manty
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Minneapolis

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The Duties of the United States Trustee

The Duties of the United States Trustee

Sarah J. Wencil

The United States Trustee program is a component of the Department of Justice that is responsible for overseeing the administration of bankruptcy cases and private trustees under 28 U.S.C. § 586 and 11 U.S.C. § 101 *et seq*. The program seeks to promote the efficiency and protect the integrity of the federal bankruptcy system. The program monitors the conduct of bankruptcy parties and private estate trustees, oversees related administrative functions, and acts to ensure compliance with applicable laws and procedures. It also identifies and helps investigate bankruptcy fraud and abuse in coordination with United States attorneys, the Federal Bureau of Investigation, and other law enforcement agencies.

The United States Trustee has standing to appear on any matter arising under the bankruptcy code, except that the United States Trustee may not file a plan. *See* 11 U.S.C. § 307. Proceedings to contest an act or failure to act by the United States Trustee are governed by Federal Rule of Bankruptcy Procedure 9014, which governs contested matters before the court. *See* FED. R. BANKR. P. 2020.

The United States Trustee's duties are listed at 28 U.S.C. § 586, which include:

- appointing and supervising private trustees who administer chapter 7, 12, and 13 bankruptcy estates
- taking legal action to enforce the requirements of the bankruptcy code and to prevent fraud and abuse
- referring matters for investigation and criminal prosecution when appropriate
- ensuring that estates are administered promptly and efficiently
- reviewing professional applications for employment and compensation
- appointing and monitoring creditors' committees in chapter 11 cases
- reviewing disclosure statements and plans in chapter 11 cases
- ensuring that chapter 11 cases progress timely
- ensuring all reports, schedules and fees are timely filed
- advocating matters relating to the bankruptcy code and rules

Title 11 (the Bankruptcy Code) also directs the United States Trustee to perform specific duties, including:

- conducting § 707(b)(2) (means test) review for every consumer case for abuse
- overseeing § 341 meetings
- appointing consumer and health care ombudsmen
- appointing a trustee where there is fraud in a chapter 11 case
- approving credit counseling and debtor education providers
- enforcing debtor identification requirements

The United States Trustee will also engage in other enforcement actions as necessary, including:

- pursuing objections to discharge under §727
- pursuing other motions to dismiss under §707
- pursuing other bad faith or fraud under any chapter
- pursuing debtor attorney misconduct under § 329, § 526-528 (the debt relief agency provisions)
- pursuing creditor abuse
- pursuing petition preparer abuse

Practice Pointers for Dealing with the United States Trustee

Local rule 2020-1 provides that trustees and debtors are required to comply with all reasonable requirements for reporting and furnishing information requested by the United States Trustee. *See* MINN. LOC. R. 2020-1.

1. Section 341 meetings

    - All telephonic or power of attorney testimony requests must be pre-approved by Assistant U.S. Trustee Robert Raschke (Robert.Raschke@usdoj.gov), who will consider the request on a case-by-case basis. Examples of reasonable cause for a telephonic appearance is military deployment, incarceration or incapacitation that cannot be accommodated by the building handicap accessibility. The case trustee is not authorized to approve a telephonic appearance or the appearance of a power of attorney in place of the debtor.

    - Interpreter requests for language interpreters should be made at least one week prior to the meeting and for sign language interpreters at least two weeks prior to the meeting. Interpreters are free of charge but the service is limited to § 341 meetings and not court hearings. Email to USTPRegion12MN.ECF@usdoj.gov with "Interpreter" in the heading and include debtor's name, case number, date of meeting, trustee, and language preference in the email.

    - A client who has moved to or is located in another state may seek prior approval to appear for a § 341 meeting at a United States Trustee office in the district where the client is located. Such approval must be made through Assistant U.S. Trustee Robert Raschke.

    - Audio copies of section 341 meetings may be emailed if 36 MB or smaller if the requester's server is configured to accept large email files. If the file cannot be emailed, a CD or DVD disc and a self-addressed stamped return envelope should be delivered to the United States Trustee's office. There is no charge for an audio copy of the meeting.

2. Document or Discovery Requests

    - Responses may be provided by hard copy, CD, DVD, flash drives, and Dropbox or other file sharing services. Please do not fax documents.

- Be professional with all United States Trustee staff. Attorneys that respond quickly and efficiently to requests for information save clients unnecessary expenditures by shortening the number of billable hours spent dealing with the United States Trustee staff.

- Inquiries are usually based on unusual fact patterns or missing information that we identify from our review of the schedules or from referrals from third parties such as trustees, parties in interest, entities with an axe to grind, etc. An inquiry is usually satisfied by submitting supporting documentation, and if applicable, a verified statement from the debtor or such other person, especially if the new information contradicts a statement previously made by a debtor under oath. A lone attorney representation about a factual matter is not sufficient evidence.

3. Referrals

- The United States Trustee encourages referrals for misconduct by a debtor, creditor, trustee, attorney, petition preparer, credit counseling agency, debtor education agency, United States Trustee employee or any other entity that engaged in conduct detrimental to the bankruptcy system.

- All referrals should be in writing (electronic or written) and addressed to Assistant U.S. Trustee Robert Raschke.

4. United States Trustee Information

- The United States Trustee web page: www.justice.gov/ust provides information that may be useful, including: credit counseling and debtor education organizations, IRS standards for the means test, other consumer information, professional compensation and guidelines.

Duties of a Chapter 7 Trustee

Duties of a Chapter 7 Trustee

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The chapter 7 trustee is a fiduciary to the creditors in the bankruptcy case. The trustee has several statutory duties set forth in Section 704 of the Bankruptcy Code. Specifically, the trustee:

i. collects and reduces to money the property of the estate and close the estate as expeditiously as is compatible with the best interests of parties in interest;
ii. is accountable for all property received;
iii. ensures that the debtor performs his intentions as to the retention or surrender of property of the estate that secures consumer debts;
iv. investigates the financial affairs of the debtor;
v. if a purpose would be served, examine proofs of claim and object to the allowance of any claim that is improper;
vi. if advisable, opposes the discharge of the debtor (but not the discharge of a particular debt since only the creditor to whom it is owed may do so);
vii. unless the court orders otherwise, furnishes such information concerning the estate and the estate's administration as is requested by a party in interest.
viii. if the business of the debtor is authorized to be operated, files with the court and with any governmental unit charged with the responsibility for collection or determination of any tax arising out of such operations, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the court or the United States Trustee requires; and
ix. makes a final report (TFR) and file a final account (TDR) of the administration of the estate with the United States Trustee and the court.

In addition, the trustee conducts the meeting of creditors and examines the debtor(s) under oath at that meeting.

Practice Pointers – Dealing with Chapter 7 Trustees[1]

A. Tips for Debtors

1. <u>Explain the bankruptcy process to your client.</u>

Not every case is a "no-asset" case. Please explain to your clients that they may have exposed assets that are non-exempt. Or, that there may be insider preferences or fraudulent transfers. This should not be a surprise to them at the meeting of creditors. It is very uncomfortable to watch the debtor panic with misunderstanding when the trustee is asking questions regarding the non-exempt assets or other litigation. Most trustee's will sell assets and resolve small preferences or fraudulent transfers with the debtor directly. They will be able to keep their assets and save their relatives from lawsuits. Also, there may be the need to provide additional

[1] I wish to acknowledge and thank John Stoebner's contributions to these materials. Some of the tips are borrowed from our Minnesota CLE presentation entitled: "The Top Ten Mistakes Attorneys Make in Dealing with Trustees."

documentation. Alert your client to this, so the debtor does not dispose of the information. Ideally, you will have the information in your file, anticipating that the trustee will request it.

Also, in joint cases, not every asset is owned by both debtors. Make sure that you designate who owns what asset. Even though debtors file a joint bankruptcy petition, the Bankruptcy Code views them as separate debtors with separate estates. *See* 11 U.S.C. § 522(m), *In re Carlson v. Moratzka*, 394 B.R. 491, 493 (B.A.P. 8th Cir. 2008)(a spouse who did not pay any of the withholdings to which a joint income tax refund is attributable has no ownership in the refund). As such, it is incumbent upon the debtors to schedule their assets separately. Not everything is a jointly held asset. If the asset is owned or titled in the name of only one debtor it cannot be scheduled as a "joint" asset. It must be scheduled separately.

2. <u>Carefully and thoroughly review the debtor's assets, debts, and any other unique issues pertaining to the debtor.</u>

It is important to carefully review with the debtor(s) their assets and liabilities in preparing the schedules and statement of financial affairs. It is especially important to focus on tax refunds, including past tax years that have not yet been received, beneficial interests in trusts, and remainder interests in real estate. For example, if the debtor is a beneficiary in a trust, you should carefully review the trust provisions because a "spendthrift" trust may no longer be protected as a "spendthrift" trust if the debtor's right to receive an outright distribution has matured. Also it may be wise to ask whether the debtor's parents have done any estate planning that might have resulted in the debtor receiving a remainder interest in real estate. There have been a number of cases where such a remainder interests have surfaced years later resulting in a re-opening of the bankruptcy estate and a trustee obtaining a significant portion, if not all, of the debtor's interest in the real estate. Similarly, debtors often fail to disclose their participation in class actions or mass tort claim litigation. This can also result in an unpleasant surprise years later when the trustee claims a significant amount of a recovery.

3. <u>When describing the debtor's assets, the more description, the better.</u>

Describing the assets will alleviate the need for additional questions by the trustee. The meeting of creditors is often intimidating for the debtors. Less questions by the trustee, the easier time for the debtors. If you describe assets as a "boat", "jewelry", "artwork", "guns", "collectibles", the trustee will ask questions at the meeting of creditors in order to ascertain its value. Better descriptions: "1985 16' Lund Fishing Boat, with 35 hp motor with trailer value determined per XYZ Boat dealer". Costume Jewelry, two necklaces, one ring, three bracelets, no precious stones or metals, purchased for $50.00 five years ago. Two prints purchased at Target for $5.00 a piece or Terry Redlin signed print, number 10 of 250. Similar prints selling on eBay for $150.00. One shotgun, 25 years old, good condition, value from XYZ Gun shop $25.00; one rife 50 years old, has not been fired in 20 years, XYZ Gun shop $5.00. Antique Dresden vase, valued on eBay for $22.00.

4. Contact the trustee prior to the meeting of creditors if there are unusual circumstances relating to the debtor.

For example, if the debtor has had to obtain a restraining order or otherwise fears that a creditor or former spouse could present a physical danger at the meeting of creditors, please advise the trustee or the U.S. Trustee and a court security officer can be present during the meeting. Similarly, if there any other special circumstances concerning a debtor that could affect the conduct of the meeting of creditors, please inform the trustee so that the issue may be addressed. If the debtor requires an interpreter, the debtor's attorney needs to request one through the U.S. Trustee's office in plenty of time, so the U.S. Trustee's office can alert the trustee. There are forms that we must complete and provide to the U.S. Trustee's office. If the debtor is hard of hearing, please let the trustee know that before the meeting commences. Also, if the debtor has moved out of state since filing, the debtor can appear at another U.S. Trustee office and appear telephonically, thereby alleviating the need to travel back to Minnesota. This is a request that you make to the U.S. Trustee's office.

5. Please provide all required or requested information to the trustee prior to the meeting of creditors.

Trustees love, love, love it if the debtors provide information prior to the meeting of creditors. The meeting will take less time for you and your client. Two things may happen if you do not provide the required information prior to the meeting of creditors, the meeting may be rescheduled or it may be non-concluded and the debtor may have to return to provide testimony on the missing information. The debtors are required to bring photo identification and confirmation of their social security numbers. This means an original driver's license, passport, military identification, etc. In connection with proof of the social security numbers, the debtor must provide his/her social security card, Medicaid card(s), W-2 or something from the Social Security Administration with the **FULL** social security number on it. Tax returns will not be accepted as proof of the social security number. Photocopies of the social security card will not be accepted. Metal social security cards will not be accepted. If the debtor does not have a picture identification or proof of the full social security number, the meeting of creditors will not be held.

Pursuant to the Bankruptcy Code and Rules, the debtor's most recent tax returns must be provided not less than seven days prior to the first date set for the meeting of creditors. If the tax returns are not provided within that time frame, the meeting of creditors will not be called or heard. If the debtor no longer is required to file tax returns due to his/her income, please provide an affidavit or declaration from the debtor giving the reason why the filing of tax returns is no longer required, within seven days prior to the first date set for the meeting of creditors. The complete state and federal tax returns are required to be furnished to the trustee.

6. Please provide required or requested information to the trustee following the initial meeting of creditors.

Pursuant to 11 U.S.C. § 521, the debtor has a duty to cooperate with the trustee as is necessary to enable the trustee to perform the trustee's duties, to surrender to the trustee all property of the estate and any recorded information, including books, documents, records and papers relating to property of the estate. If the trustee has requested documentation and the documentation has not been provided before the meeting of creditors, the trustee reserves the right to continue the meeting to his/her next calendar. Keep in mind that even if the trustee holds the meeting of creditors without the requested documentation, the trustee may non-conclude the meeting of creditors and require the debtor to return to a continued meeting for further testimony. By providing the documentation in advance of the meeting, a continued meeting may be avoided. If a trustee requests information following the meeting **carefully** read the trustee's request and respond to **all** of the trustee's requests to avoid unnecessary additional back and forth communications. Moreover, if the trustee cannot obtain the required information from the debtor, the trustee will go to third-party sources through the subpoena process. This means that friends, family members, business associates, financial institutions, etc., may be required to provide the information to the trustee.

7. Let's Make a Deal.

Frequently a debtor will have several items of non-exempt personal property. Often the trustee will sell these items back to the debtor. Do not "cherry pick" these items by offering to purchase one or two of the items and offering to turnover physical possession of the others. When such items are turned over to the trustee, normally the trustee must hire an auctioneer and sell the items at auction. In order for that process to work, the trustee generally needs to have a critical mass of value and thus will want to sell **all** of the non-exempt items at auction, not just a few of them. There can be exceptions to this rule and debtor's counsel should consider the specific facts and circumstances of each case before conveying offers by the debtor to purchase non-exempt assets from the bankruptcy estate.

8. Legal Descriptions.

If debtor intends to exempt real estate (home), the full legal description must be on schedule A and C. If not, and the debtor intends to sell home, it will need to be reopened and amended in order to have a certificate of exemption at closing.

9. Bank Statements.

Check bank balances as of the date of filing and adjust the bank balance on the schedules. Also, look for large withdrawals or payments in the months preceding filing. Explain it on the statement of financial affairs.

B. Tips for Creditors

1. Appearances at the Meeting of Creditors.

If you are appearing and asking questions at the meeting of creditors, please notify the chapter 7 trustee before the meeting. We will adjust our calendars accordingly. However, the meeting of creditors is not the proper forum to prove up nondischargeability of your client's claim. Rather, use a 2004 examination as a forum to question the debtor.

2. Relief from stay or Abandonment.

When requesting a trustee to stipulate to stay relief or abandon an asset, please provide the promissory note, lease, security agreement, perfection documents, evidence of the obligation remaining and the fair market value of the asset. This will assist us in our decision-making process. Remember: if you are filing a stipulation for relief from stay, the court still requires a filing fee.

3. Save Money.

If you do not want to spend the time or money in attending the meeting of creditors, but have information that may lead to recovery of missing assets or will assist the trustee with the administration of the case, please provide the information to the trustee before the meeting. Share financial statements or other information that you or your client may have. Compare your financial statement with the debtor's schedules. The trustee will follow up on the information and will report back. Sharing information may result in payment to you or your client.

4. Proofs of Claim.

If the trustee has monies to distribute, the bankruptcy court will send out notice to file claims. When filing proofs of claim, please attach documentation to support your claim. Also, amend the claim if necessary. The claim is signed under penalty of perjury, so accuracy is key. Also, redact sensitive information. *See* Bankruptcy Rule 9037.

Filing a proof of claim may be viewed as a waiver of any objection a creditor may have to the jurisdiction or authority of the bankruptcy court. A federal, state, or municipal creditor may waive its sovereign immunity by filing a proof of claim. *United States v. Metropolitan St. Louis Sewer Dist.*, 578 F.3d 722, 725 (8th Cir. 2009). Under the Supreme Court's decisions in *Langenkamp v. Culp*, 498 U.S. 42 (1990), and *Granfinaciera S.A. v. Nordberg,* 492 U.S. 33 (1989), by filing a proof of claim, a creditor submits to the equitable jurisdiction of the bankruptcy court and thereby waives any right it may have had to a jury trial in a subsequently commenced preference action.

5. Sale of Assets.

If you or your client have a perfected security interest in an asset with equity, you may want to work with the trustee to sell the asset. Not only will it save your client money, but your client will be paid in the process.

6. Non-Exempt Assets.

The stay remains in place, after the debtor's discharge, as to non-exempt assets. Do not assume that because the discharge has been granted, the stay no longer applies. Check to see if it is non-exempt. The trustee may be administering the asset. You do not want to violate the automatic stay.

7. Preferences.

If you receive a preference demand letter from the trustee, please do not ignore it. You can probably settle the matter more reasonably before the lawsuit is filed. If the trustee has to incur professional fees and costs because the trustee has not received a response, those costs will be added to any settlement reached.

Chapter 12 Trustee Duties

CHAPTER 12 TRUSTEE DUTIES

Michael J. Gieseke

A Chapter 12 Trustee performs many of the same duties as a Chapter 13 Trustee, and has the similar central duty of distributing to creditors moneys received from debtors. *See* 11 U.S.C. §§ 1202 & 1302. The Trustee must appear at any hearing concerning the value of property subject to a lien, confirmation of the plan, modification of the plan, or the sale of estate property. 11 U.S.C. § 1202(b)(3). The Chapter 12 Trustee will also be required to conduct the debtor's business (in a capacity similar to that of a Chapter 11 Trustee) only if the debtor ceases to be a debtor in possession. 11 U.S.C. § 1202(b)(5). As in Chapter 13, the Chapter 12 Trustee takes an active position in ensuring the debtor meets the disposable income test, best interest of creditors test, and other requirements of sections 1222 and 1225. While the Chapter 12 Trustee cannot give legal advice, the Trustee does have a duty to advise the Chapter 12 debtor on matters relating to the plan that do not involve legal advice.

PRACTICE TIPS AND POINTERS FOR DEALING WITH THE CH. 12 TRUSTEE

I. TIMELY FULFILL DOCUMENT REQUESTS

In each Chapter 12 case filed in Minnesota (and North Dakota), the Trustee requests that the debtor submit the following documentation within two weeks of the filing of the case:

- 3 months of bank statements, working back from and including the date of filing
- Summary of operations
- Proof of insurance on all real and personal property
- Bank account reporting form
- Debtor in possession account verification
- Liquidation analysis
- Tax returns for the three full calendar years preceding the date of filing

The Trustee recognizes that some Chapter 12 filings must take place on an expedited basis with imperfect knowledge and documentation. That said, many Chapter 12 filings follow extensive contact with debtor's counsel, possibly through Farmer-Lender Mediation. Having the documents in line, and submitted via email simultaneously (rather than piecemeal) avoids many problems down the road with delay or continuance of the 341 meeting of creditors, eligibility disputes and confirmation issues.

II. REVIEW TAX RETURNS AND ANALYZE TOTAL DEBT

An individual that walks through your door may appear to be a farmer in the common-sense definition of that term. However, aspects of a debtor's earnings may not qualify as income arising from a "farming operation" for purposes of eligibility. Given the dynamic nature of modern farming enterprises, a debtor might be involved in activities that constitute both farming and non-farming operations. In such circumstances, a court will make the distinction between the farming and non-farming operations of the debtor. Although not necessarily conclusive evidence, tax returns are the best starting point in the determination of whether an individual meets the income requirements of 11 U.S.C. § 101(18)(A). In addition, it behooves debtor's attorneys to be mindful of the $4,153,150 total debt limit for Chapter 12 eligibility before filing a Chapter 12 case. Farmers may have considerable secured and unsecured debt even in modest sized operations. Having a firm grasp on a debtor's income and debt eligibility for Chapter 12, and having the documentation to explain it to the Trustee, will help you and your client move beyond this common stumbling block.

III. FILE A COMPLETE APPLICATION FOR EMPLOYMENT

Given the similarities between Chapter 12 and Chapter 13, the Trustee often sees Chapter 13 debtor's attorneys take on Chapter 12 cases. Not all aspects of practice under Chapter 13 directly carryover to Chapter 12, however. Unlike Chapter 13, debtors-in-possession in Chapter 12 are required to file an application to employ an attorney, transmit the application to the U.S. Trustee, and receive court approval pursuant to 11 U.S.C. § 327(a) and Local Rule 2014-1. Debtor's attorneys must also file a supporting affidavit "setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." *See* Fed. R. Bankr. P. 2014(a). The Trustee sends a reminder email to debtor's attorneys in each case reminding them to have the debtor file an application to employ them as the attorney for the case. Even seasoned Chapter 12 attorneys overlook this requirement from time to time, so please take notice of this reminder and file the application as soon as possible after the case is filed.

IV. TIMELY FILE A PLAN

In Chapter 13 cases, plans are normally filed at the same time as the petition. In the event that plans (or other documents) are not filed at the outset of the case, the court enters an order directing the plan to be filed within 14 days or the case may be dismissed without further notice. In Chapter 12, a debtor must file a plan not later than 90 days after the order for relief, unless an extension is requested. However, there is no notice provided by the court of that impending deadline. The Trustee sets up reminders for each case to ensure that plans are timely filed. If a plan is not timely filed, the Trustee will move to dismiss the case. A debtor's attorney's failure to timely file a plan may also be sanctionable, pursuant to Local Rule 1007-4. Setting up calendar reminders is advisable so this critical deadline is met.

V. REVIEW SECURITY DOCUMENTS; SEND COPIES TO THE TRUSTEE

The Chapter 12 Trustee reviews security agreements and perfection documents closely. If a secured creditor does not file a claim showing the grant of security and perfection, the Trustee will object to plan provisions that seek to treat such creditors as secured. The debtor may not have all of that documentation on-hand, so acquiring those documents from the secured creditors early in the case lessens confirmation issues related to the secured status of these creditors.

VI. BE SPECIFIC ABOUT PAYMENTS UNDER THE PLAN

The terms and format of the Chapter 13 form plan for the District of Minnesota largely and helpfully eliminate issues regarding disbursement, payment due dates, and lien retention. No form plan exists for Chapter 12, however, so attorneys should be clear regarding the disbursing agent (Trustee or debtor) for each class of creditors, the due dates of payments, which are often annual, and how each secured creditor's lien will be treated in the plan. Including a table to show the payments, payment dates, and the amount of Trustee's fees due on such payments adds clarity for the Trustee's administration of the plan and for the debtor's understanding of his/her obligations under the plan.

VII. INSTRUCT DEBTOR REGARDING MONTHLY REPORT REQUIREMENT

The Chapter12 Trustee has a different level of involvement when compared to Chapter 13, notwithstanding the Chapter 12 debtor's designation as debtor-in-possession. The Trustee reviews monthly reports and bank statements to ensure the debtor is properly managing the farming operation. Monthly reports and the annual turnover of tax returns are also vital to the determination of a debtor's disposable income payment that is disbursed to a debtor's general unsecured creditors. In contrast to Chapter 13, a Chapter 12 debtor's disposable income is calculated either on an annual basis of over the entire term of the plan due to the largely unpredictable nature of farm income.

VIII. REVIEW HOMESTEAD EXEMPTION DOLLAR & ACREAGE LIMITATIONS

If a Chapter 13 debtor elects Minnesota exemptions to preserve homestead equity, the $420,000 limitation is normally the only figure implicated. However, when a Chapter 12 debtor elects Minnesota exemptions to preserve homestead equity, a debtor's attorney should be mindful of the $1,050,000 and the 160-acre limitations of Minn. Stat. § 510.02, subd. 1. The Trustee often must object to a claimed exemption as it encompasses a parcel of real estate that exceeds 160 acres. To avoid these issues, Schedules A/B/C should separately reflect the value of the 160-acre parcel claimed as exempt and the value of the remainder of the parcel. An appraisal of the homestead and building site, as well as evidence of value of farmland, will also help avoid issues related to a claimed homestead exemption.

IX. REVIEW THE TRUSTEE'S OBJECTION AND CALL THE TRUSTEE

As in Chapter 13, the Chapter 12 Trustee will likely have an objection to the first plan filed. The Trustee extensively reviews these plans to ensure debtors meet the disposable income test, best interest of creditors test, and other requirements of Sections 1222 and 1225. If you disagree with an aspect of the Trustee's objection, a phone call or email to the Trustee is likely the quickest way to resolve issues. It doesn't benefit you, your client, or the Trustee to leave objectionable terms in a subsequently filed plan. Addressing the Trustee's concerns early on can expedite confirmation of the plan.

X. READ THE MINNESOTA CLE DESKBOOK

The Chapter 12 and his Trustee have put considerable time and research into drafting a chapter on Chapter 12 bankruptcy practice in Minnesota, which is published by Minnesota CLE as part of the Bankruptcy Practice in Minnesota Deskbook. In that chapter, you will find an extensive discussion of eligibility issues, Chapter 12 benefits, approaches to drafting schedules and plans, lease assumption/rejection, dealing with motions for relief, freeing up cash collateral, and handling all types of pre- and post-confirmation issues that may arise. The Deskbook is equally beneficial for those tackling a Chapter 12 case for the first time and for those seasoned filers looking for a thorough reference guide to have on hand.

Chapter 13 Trustee Duties

Chapter 13 Trustee Duties

Jeffrey M. Bruzek

The chapter 13 trustee's duties are found in 11 U.S.C. § 1302. The chapter 13 trustee performs some of the same duties as a chapter 7 trustee such as being accountable for property received, filing objections to claims and discharges, investigating the financial affairs of the debtor, and filing final reports. Additionally, the trustee shall "appear and be heard" at any hearing that concerns the value of property subject to a lien, confirmation of a plan, and modification of the plan after confirmation. The trustee is the primary disbursing agent for the chapter 13 debtor's plans of reorganization, and most importantly must advise, other than on legal matters, and assist the debtor in performance under the plan

It is commonly stated that the chapter 13 trustee "works with everyone and for no one at the same time."[1] The chapter 13 trustee encourages an exchange of dialogue with creditors and debtors alike during the pendency of the case to achieve the trustee's mission of a timely and efficient administration of these chapter 13 bankruptcy cases for all parties involved.

Ten Practice Pointers to Ensure a Smoother Bankruptcy Case

The First Three Do Not Require a Law License to Understand

1. Be on time.

Hearings start at a certain time. Try to be there early. If it is a hearing with a judge, it will give you time to perhaps resolve, or at least discuss with opposing counsel, the matter. If it is the 341 meeting, it will allow you time to properly prepare your client for the meeting. Everyone has a mobile phone with a clock. Most have a navigation system that tells you how long it will take to commute. There are parking apps that can assist in locating open spots. Use all of these, and assist your clients with the same, in order to be there on time. Everyone wants to complete the hearing, so delaying it needlessly is not in anyone's interest. If you are running late, please contact the trustee's office so, if practical, we can adjust accordingly.

Timely file written responses so the trustee does not have to address last minute submissions to the court. Read the local rules regarding service for the motions you file. If it says 14 days, it means 14 days.

2. Do what you say you are going to do.

The chapter 13 process is comprised of a lot back and forth between the parties to get the case to confirmation and then to discharge. If you tell the trustee that you are modifying a plan, or providing documents, please follow through. If you cannot complete that task at least let the trustee know the status. If the judge continues a confirmation hearing for you to do something for

[1] 1 Keith M. Lundin, Chapter 13 Bankruptcy § 58. 1, at 58–1 (3d ed. 2000 & Supp.2006).

your client, please do not ignore the directive given from the bench. Everyone wants these cases to move forward, and when the court tells you what to do the odds are that they are not trying to send you on a wild goose chase. We get it, everyone is busy, and your clients (debtors and creditors) are non-responsive. Nonetheless, a status update helps immensely.

3. Be kind.

A little sun can make a garden grow. Minnesota is fortunate to have a very amicable bankruptcy bar. However, and somewhat understandably, tensions can run high. Make sure the debtors understand that being standoffish at the 341 meeting, or perhaps worse, evasive, will make for a long hearing. Likewise, if the debtor later provides a written statement explaining their financial affairs, the tone[2] of the response can drive the resolution of the issue. Read the debtor's response before it is forwarded on to our office. Be respectful in any disagreements we have may have, as there is no reason to make it personal.

For creditors, if you have an issue with a case, give the trustee the facts so we can investigate before the 341 meeting. If you are attending the 341 meeting and have questions, get to the point, get your answers, and move on. Beating the issue to a pulp at the meeting can have diminishing returns.

Professionalism, kindness, and perhaps good humor with a smile can make the process palatable for all.

The seven practice tips that may require a law degree

4. Read the instructions and provide the information on the schedules.

Make sure the petition and schedules are reviewed prior to filing to eliminate errors, typos and omissions. For example, clients are unlikely to appear for their meeting of creditors naked, so failing to list clothing on Schedule A/B is an obvious error (and one seen more than once). Most have some costume jewelry. The best practice is to have the clients come to your office to review the petition, schedules and plan in detail so errors and omissions can be addressed prior to filing. While the chapter 13 trustee is not a liquidating trustee, you should be as detailed as the chapter 7 trustee requires for assets so that we can determine if the best interest test is met.

The instructions to the form are not suggestive. The information is required, please provide it. Instead of just listing "mom" as the recipient of a transfer or preference, please provide the name and address so we do not have to waste time at the 341 meeting digging for it. Schedule I requires the detailed information of the place of employment for both debtors, even for the non-filing spouse.

When drafting the plan, place treatment for each creditor in the proper part so it is clear what the claim is for. Always check the box in part 1 if the plan meets those requirements and always calculate the trustee fee in Part 3 at 10%, so the debtor can pay all claims as desired and

[2] "Entitlementitis" was coined by staff counsel.

does not end up with a motion to dismiss for plan buster claims. Serving the plan pursuant to Rule 7004 can avoid problems in the future when attempting to request lien releases, formally and informally.

5. <u>Manage client expectations and have a mutual understanding of the game plan for the case.</u>

Creditors should understand that they may not get every penny that they are owed in a case. Debtors who own businesses fail. It happens. A creditor who does not understand that will rack up huge attorney fees without changing their return. It is understandable if they want to object to the plan, but it may not pay off as they like.

Debtors need to know what is going on with their plans. They need to be aware of plan payment increases, additional payments (e.g. taxes, sale proceeds, bonuses), and to whom direct payment is made by the debtor and to whom the trustee makes disbursements. If the debtor is not entitled to a discharge, make sure they understand that. If the case is designed to obtain confirmation while waiting out a loan modification, make sure the debtors understand that as well. At the end of a case, there is nothing worse than a debtor who calls the trustee's office with a list of questions because of a misunderstanding on what they thought was going be paid and discharged. The debtors should also understand that they may have to "tighten the proverbial belt" while in chapter 13. What was the norm before filing the case may not be allowed to continue during the case.

Always confirm with your client how they are going to make the trustee payments. The highest rates of success in chapter 13 are those on wage orders or other automatic payment methods such as ACH or the TFS system, which allows them to make payments when the funds are available rather than on a set date. These methods can help the debtors who have routinely struggled pre-petition to operate in a post-petition "out of sight out of mind" paradigm. This will ensure the funds are not spent elsewhere before sending the plan payments to the trustee.

6. <u>Follow up with your client during the pendency of the case post-confirmation.</u>

Creditor's lawyers, especially if you are representing a jilted spouse or a dejected business partner, follow up with your client to see if there is any additional information about the debtor that could support a post-petition modification of the plan, instead of waiting until the end of the plan when a modification may be impossible. Likewise, waiting while three years of post-petition direct payment arrears accumulate to start a lift stay proceeding seems counterproductive to everyone. Finally, the deadline to file claims has been shortened dramatically for all non-governmental creditors and those deadlines may affect your client's rights.

Debtor's lawyers should follow-up with their clients, as least annually, with a quick correspondence to ensure that the debtors are in compliance with their plan. It is better to find out about a change in circumstances when it is happening instead of the end of the plan.[3] A failure to

[3] *Germeraad v. Powers,* 826 F.3d 962 (7th Cir. 2016); *See Carroll v. Logan,* 735 F.3d 147, 151-152 (4th Cir. 2013)

make direct payments could lead to a denial of discharge or case dismissal.[4] If the debtor has unfortunately incurred post-petition debts (e.g. medical expenses), perhaps a conversion better suits their needs than a discharge. Also make sure your clients are aware that they need to pay over bonuses and tax refunds before the money is spent.

7. 341 Meetings.

Arrive at the 341 meeting room early enough to confer with your clients before the case is called to reassure them that the hearing is routine and that they will be fine if they answer questions honestly and completely. The good attorneys always seem to be there in advance of the hearing reviewing schedules with clients and calming their clients before the case is called. Make sure clients correct, on the record, any errors discovered at the last minute. Please have a copy, electronic or paper format, of the schedules and plan available to show the debtors during the hearing.

The rules provide for what items are mandatory to bring to the meeting. Photo identification and proof of social security numbers are needed to prevent identity theft. For financial accounts, have the debtors get a screen shot of their bank balances as of the date of filing to correct any errors as to the balances at filing, as well as to confirm if any of the originally listed accounts were closed at filing. If so, move them to Item 20 on the Statement of Financial Affairs so less time and effort is spent chasing statements or closing information for them. Add any missing accounts before filing the schedules to avoid the need to amend them later. Remember that the trustee wants bank statements, not just screen shots, but getting the screen shots for filing purposes will cut down on errors in balances on the schedules. Recent paystubs are very important as it will allow the trustee to review the current income of the debtor.[5]

Evasiveness and belligerence are not appreciated. While trustee's counsel understands that some of it may be due to nervousness, such attitudes may make it necessary for the trustee, as a fiduciary, to conduct additional investigation to ensure that all information was true and accurate at filing.

8. If asking for relief in the form of a motion or other request remember your audience and answer the two questions of "Why am I here, and What do you want done about it?"

When filing post-confirmation modified plans, the local rule requires (if the plan payment is being reduced) a detailed revised schedule I/J as an attachment to the motion and the changes should be highlighted by striking through the old numbers. Best practices in these instances have a detailed explanation in the motion concerning the debtor's changed financial circumstances. Just citing "less income, increased expenses" without detail requires investigation by the chapter 13 trustee that could be avoided if the need for modification is made clear, especially if the percentage return to unsecured creditors is to be reduced. The motion should also include receipts as an attachment for unexpected expenses that are referred to in the motion. Likewise, if

[4] *In Matter of Kessler*, 655 Fed.Appx. 242 (5th Cir. 2016); *See In re Heinzle*, 511 B.R. 69, 74 (Bankr. W.D. Tex. 2014); *In re Gonzales*, 532 B.R. 828, 832 (Bankr. D. Colo. 2015)

[5] Failure to bring any of these items could result in the 341 meeting being rescheduled to a later date and time.

you are filing a motion to extend the stay or for other relief, please be thorough in the factual basis that supports your motion, and some recitation of law that allows you to do what you are asking. The clearer the reasons for the modification or other relief, the easier it is for trustee to recommend confirmation.

Lift stay motions should make it clear how the plan treats the claim and either why that treatment justifies relief or how the debtor is not complying with that treatment.

9. Be proactive.

Obtain documentation for the debtor's unusual expenses[6] or assets[7] in a case so that you can easily provide them to the trustee near the 341 meeting if requested. An explanation of benefits for medical expenses is a perfect starting point for a review of those medical expenses. Any documentation that supports the plan step-ups (e.g. car payment and retirement loan statements) will help speed the process to confirmation. With the new tax laws taking effect in 2018, many debtors will no longer itemize their deductions and accordingly the trustee will need to document those expenditures more so than before. During the pre-confirmation process contact the trustee with a list of cases that you have pending and the status of any document requests or other updates.

Creditors should contact the trustee's office before the 341 meeting with any information that may be helpful while investigating the case. To the extent there is documentation (e.g. UCC form with lists of assets or a financing statement), the best practice is to send those items over for review so we do not have to search on our own for them. Your complaint with a case will get further along the more it can be substantiated. If you have an objection to confirmation in a case approaching confirmation, please contact the trustee as soon as possible if you are continuing the objection, if the objection to soon to be resolved, or if you plan on attending the hearing. It lets all parties efficiently prepare for the calendar, including the court.

10. Call me.

If you have a question please contact our office. The main goal in chapter 13 cases is to move the case to confirmation so the trustee can commence disbursements. If the pre-confirmation status report outlines objectionable expenses, our office may be willing compromise if a resolution can be achieved quickly to avoid filing objections and clogging the docket. If you are unsure how our office would view a legal or factual issue we certainly will discuss it with you in a non-binding setting to assist you.

6 "You know it when you see it." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) Justice Stewart, concurring.

7 Unusual makes and models of cars and non-exempt real estate is the most common. Marijuana businesses or products are potential assets will also need to be addressed in the case. *In re Johnson*, 532 B.R. 53 (Bankr.W.D.Mich. 2015)(chapter 13 case); *In re Arenas*, 535 B.R. 845 (BAP 10th Cir. 2015)(chapter 7 case); *In re Rent-Rite Super Kegs West Ltd*., 484 B.R. 799 (Bankr.D.Co. 2012)(chapter 11 case).

Ethics: The Bonehead Play

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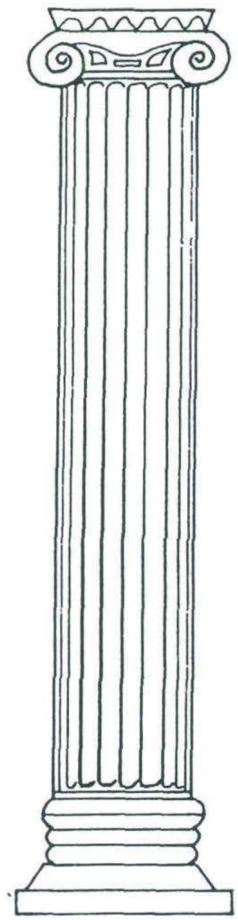

The Bonehead Play

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THE BONEHEAD PLAY

*Mark D. Yochum**

The bonehead play is a mistake, elicits an expletive, produces embarrassment, puts you in the doghouse, and makes a reputation. The bonehead play is also a daily occurrence, like sleep in your eye and a vacant stare. Any lawyer who has had some chances has fashioned a few. The grandiose yet bonehead errors of legal practice form cautionary tales, cases for citation. Examples for education in the law are regularly wrought from its inattentive practice. While some of these precedents may clutch at the heart, most of law's bonehead plays are told with a sour air, the dinge of legal malpractice or legally unethical behavior, of ruin for the lawyer or derision for his capacity. Discussion of the commonplace errors of daily practice is not a large part of the literature. Rather than actively inspiring excellence, the law produces proverbs in which a minimum of performance is set.

We first focus on making the lawyer adept. Particular ethical violations are then explained; the sanctions, illustrated. Law, itself reflective often of what is of minimal social expectation, fills thoughts. Inspiration to act beyond these minimums by lawyers is left to the rest of life. Unfortunately, life does not always inspire the elevation of conduct to higher goods or to simple competence.

Inspiration to excellence might be possible through argument, given the clever preacher and a quick and responsive congregation. Rational or persuasive bases for achieving excellence can be established given an actor's perception of the good. But the drive beyond self-interest required for true achievement and perseverance can rarely be found in reason. Emotions must be moved as well; personal satisfaction, well-being, accomplishment, perhaps even love and hate, must be a part.

For such inspiration, people turn not only to the contemplative, the spiritual, and the sublime, but to the recreative and the physical. When the inevitable venial sins of legal practice are committed, consciences, not cleared by confession and penance, are sometimes eased by a vigorous walk through the park, a steam bath, some basketball,

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riding a bike with your children, watching the play of sport. The lessons of sports and the ethic of sportsmanship provide particularly vivid instruction when recalled in the humdrum of the sedentary lawyer's life to move beyond the barest bones of competence.[1]

As an example of such tales, here is the bonehead play,[2] a mental error committed in a baseball game in 1908 by New York Giants' first baseman, Fred Merkle. The trivialist of today will still thoughtlessly respond, bonehead, to the name, Merkle. Merkle's violation was of a technical nature, not related to physical ability, a simple rule disregarded, the bane of many the lawyer whose wits for awhile are elsewhere. This bonehead play led, however, to a trail of dishonesty, cover-up, disputativeness, hairsplitting, violence, and death.

Throughout 1908, the New York Giants, managed by John McGraw, fought the Chicago Cubs, managed by Frank Chance, for the National League pennant. The race for the pennant in 1908 brought the sporting public to the parks in spades where teams in the thick of the matter fought, Chicago, New York, and Pittsburgh (with Honus Wagner). In New York, the Polo Grounds, where the Giants played, was expanded several times during the season. Eager crowds watched baseball, separated from the field sometimes only by a taut rope or their own sense of decorum.

Frank Chance managed the Cubs while playing first base. Tinker was at shortstop and Evers at second. In 1908, Chance was thirty and had planned to be a doctor. He had managed the Cubs to the National League pennant in 1906 and 1907 after the Giants had won in 1904 and 1905. The Peerless Leader, though young, was like a senior part-

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1. For a similar suggestion, see Macaulay, *Images of Law in Everyday Life: The Lessons of School, Entertainment, and Spectator Sports*, 21 LAW & SOC. REV. 185 (1987).

2. Information and comment about the bonehead play in the sporting press and in oral tradition is legion. All of the information contained herein about what occurred, however, may be found in two works, L. RITTER'S, THE GLORY OF THEIR TIMES, and G. FLEMING'S, THE UNFORGETTABLE SEASON. Ritter's book is a collection of conversations he had with the men who played in the earlier days of organized baseball. While sports books lack a reputation for art, this book is so moving, with men in the winter of life contemplating effortlessly baseball's spring and their own youth, that many reviewers call it the best baseball book written. Fleming's book is an historian's work, recreating the actual press accounts of the entire 1908 season which was capped by the replay of the game which had been untimely ended with the bonehead play. The book is funny and informative, yet has the air of classic tragedy as Merkle and his team inevitably fall, doomed by human frailty. *Sports Illustrated*, which has a circulation which at least suggests currency, recounted the tale recently. *See* Gammons, *Septembers to Remember*, SPORTS ILLUSTRATED, (Sept. 14, 1987).

ner, combative, feisty, mean. John McGraw, Little Napoleon, was the equally tough senior partner next door. In 1907, the Giants had finished fourth behind the hated, boastful, swaggering first place Cubs and McGraw was well fired for Chicago when, late in this long tough season, they came to the Polo Grounds, tied for first place with the Giants.

On September 23, 1908, between 13,000 and 20,000[3] packed the grounds to watch Christy Mathewson, the all-American boy, duel Pfiester, a port-sider for the Cubs. Tinker hit a homer for the Cubs. The Giants scratched for a run. In the bottom of the ninth, the score was tied at one. The Giants are at bat. If they score, they win. If they do not, the game continues into the approaching dusk.

In the bottom of the ninth, with one out, Devlin singles. McCormick follows but forces Devlin. With McCormick now on first, Merkle comes to the plate. There are now two out. Here we might attempt to quiet the noise of the crowd, that dissonant background which, whether for or against you, causes the blood to run, the vision to blur, and the mouth to dry. Fingers must play across the bat handle, seeking purchase easily bought on quiet empty fields but dear here. To the young lawyer, this scene, with its physical manifestations, is no great stretch from the sweats of early practice. While confident of skills learned in schools, the pulse more than quickens when the urgent pitches you must handle are fired from an experienced opponent, a demanding client, an irascible judge. Merkle was a rookie, too, and had not played first base that season. Fred Tanney, the Giants' regular first baseman, did not feel well enough to play this day. The noise returns and Merkle sees the pitch. He makes a hit, exuberantly reaching first as McCormick, the winning run, reaches third. There is a chance for the Giants to win; a hit will drive the winning run home.

The excellence which a player of a sport seeks is to maximize all of his skills. If those skills, speed, endurance, dexterity, and the rest render him beaten, the player is not despondent but proud. He has done his best; he was beaten fairly. To the Giants' fans, in wintry contemplation of Merkle's denouement, it was icily clear that that which fails a player is often not lack of physical ability but rather the mental ability to marshal his tangible assets. In fact, contests are designed in many sports to provide that winning between players of physical equality is determined more by mental acumen than luck. Losing by reason of an oppo-

3. Crowd estimates of the day were just that, judgments of the sporting press or police or the figures that the owners released, which were both of questionable veracity and accuracy.

nent's special wit, experience, or imagination is not dishonoring as long as one learns by the experience.

On a late summer's afternoon (if we yet played in the daylight) with the wet smells of grass (if we grew grass) in the Polo Grounds (gone), this romance could take a misty hold. The young left-handed lawyer takes the mound, brief in hand, the last rays of sun glinting off the steely eyes of his lawyer opponent at the plate. The brief flies, the batsman misses, and umpire-eous judge gavels, "Out!" and there is pandemonium. Today, a telephone rings and the ordinary life of the ordinary lawyer is refilled with regularity and sameness. There are no crowds, no tests. This monotony hypnotizes one to a banal level of performance. Conversely, if you practice in pandemonium, the cacaphony of business does not allow for contemplation of the foregoing pastoral. The rapidity and urgency of the game often requires such full alertness that the mind has no room for more. Boredom or panic empty the head from the matter at hand.

With enthusiasm, Merkle takes a lead off first base. He need not score. His run means nothing. The game will be over and the Giants will win when McCormick on third scores. Al Bridwell, an older head, is at the plate. He steps out of the box and looks at the rookie. Merkle has wandered far off first and Bridwell fears he might be picked off. He motions Merkle to move closer to the bag. (He's halfway to second, Al might have thought.) Merkle moves back but his mind and his body must have been jumping and skittering.

The habit of the men who played the game in 1908 was to rush to the locker room after the game. Rapid departure from the field displayed professional coolness. Further, the blandishments of success were often waiting there, food, drink, reporters, fulfilling all sorts of needs unconnected to the sport at hand. To this day there is little lingering on the lists after triumph or defeat. For youthful Merkle the pressure to run off the field on this day of all days when the Giants and baseball seemed to be at the Universe's center, if the winning run were to score, must have been enormous.

Artie Hoffman played center field for the Cubs and, with runners at the corners, he must have been on full alert. A week earlier Artie had planned to marry one Rae Looker (who, no doubt, was one) but Chance had talked him out of it for the good of the team or by threat to dock him pay. Undistracted by love, he, perhaps with more calm, reviewed the alternatives open to him if the ball were batted by Bridwell his way. One particular rule was in the back brain of all Cubs that day, placed in their collective conscious by the Peerless Leader.

The runner on first base must reach second before a fielder gets a fair batted ball there and, most importantly, if the third out is made through such a force play, the runner crossing home from third does not score.[4]

While the origins of baseball's laws have purposefully been mythologized and made uncertain,[5] this particular rule is a venerable one and critical to the elegance of the game. In 1908, there was no question before or after the bonehead play that the rule was the rule. As with the law, the pressure comes with application to the facts; additionally, heat is generated by its enforcement. The rule was so axiomatic, so rarely breached, that, when the head was filled with furor, it became trivial, simply missed.

Nearly three weeks earlier, on September 4, 1908, the Cubs had played the Pirates in Pittsburgh. In the bottom of the ninth, the Pirates scored the winning run on a play in which the runner on first, Gill, ran into the clubhouse, rather than going to second. Chance's men retrieved the batted ball which had driven in the run, touched second base, and demanded an out call. Justice, however, in the person of umpire Henry O'Day, was blind.

In modern law, the presence of the umpire is an unquestioned verity. In dispute, although there are other forms of resolution, resort to the ultimate arbiter supplied by the state is the final solution. As lawyers, we know that the existence of such a judge colors the play of the game by the contestants. In child's play, lacking an umpire, we call them on ourselves and if we cheat or lie in this task our playful friends will expel us from the game or brand us cheaters. With an umpire, we are silent about our trespasses, hoping they will go unnoticed by our opposition or the referee. In 1908, the presence of the professional umpire was developing in baseball. In Pittsburgh that day, there was only one, O'Day, and he told Chance that he did not see the play. After all, O'Day may have thought, the run should have scored, the

4. The rule as it was in 1908: Rule 59. One run shall be scored every time a base runner, after having legally touched the first three bases, shall legally touch home base before three men are put out; provided, however, that if he reaches home on or during a play in which the third man be forced out or be put out before reaching first base a run shall not count. A force out can be made only when a base runner legally loses the right to the base he occupies and is thereby obliged to advance as the result of a fair hit not caught on the fly.

5. *See, e.g.*, P. LEVINE, A. B. SPALDING AND THE RISE OF BASEBALL (1985). This work is an excellent account of the manipulation of the game's history for profit by the enterprising Spalding, including the tale of Abner Doubleday fabricating baseball at Cooperstown, New York.

Cubs should have lost. This attempt to steal away a win through the merest of technicalities is unsportsmanlike and it is a good day to be blind.

Chance ranted in Pittsburgh and the Cubs formally protested O'Day's decision. President Pulliam of the National League heard Chance but affirmed O'Day. The judgment call of the umpire, whether or not the runner went to second, as the factual determination of the trial court, will not be reversed; there was no legal error. O'Day did not see Gill fail to touch second; but O'Day assumed he did touch it. Chance lost but his mind was alight and now O'Day, too, was sensitized to possible transgressions of the rule.

On September 23, 1908, Henry "Hank" O'Day is in the Polo Grounds behind the plate, calling balls and strikes. Another umpire, Emslie, is in the field, behind second base, in the fashion of the day. The ball is pitched to Bridwell and he smacks it over second base; McCormick flashes home with the winning run. Emslie rushes to first as the ball is hit to call a play there if there is one. Bridwell crosses first base safely. Giants' fans in gigantic din break onto the field. Where is Merkle? Where is the ball?

The bonehead play, a mistake in a common level of performance, harms the player and his team through the ordinary penalties exacted by the game for errors. As in law, it can result, in a contested matter, in losing outright or making winning more difficult. Worse, on the human scale, are those mistakes which snatch defeat from victory's jaws. But, if error is to be decried in sport and law as a blot on the pursuit and a betrayal of those who trusted, the aftermath of error compounded by lying and litigiousness, is more degrading. Truth is obscured by tales told with self-interest, to place blame elsewhere, to assign fault to the stars and not ourselves. Regardless, when telling moral tales for inspiration, the history of the event is less important than the lesson learned. Here history is as uncertain as Mrs. Palsgraf and the scale, but the story of what might have been so is arresting enough. As Bridwell's hit ran to the outfield, as McCormick ran home, as Hoffman gave chase, something close to the following happened.

The crowd erupts onto the playing field, celebrating victory. Hoffman fights through them to the ball. Hoffman struggles in the melee to throw the ball to Evers, who stands at second. Merkle, poor Merkle, does not run to second where he would have been easily safe, then free to run amok. He makes the bonehead play by running into the clubhouse. Now the crowd is everywhere and Hoffman's throw gets past Evers. Now the Giants, at least those left on the field (for many had gone with Merkle), have a glimmer of what is happening. Chance is at second berating O'Day. The umpire, remembering the incident in Pittsburgh (and its aftermath), had gone purposefully to watch second base as the ball was hit. At second, O'Day had yet to see Merkle or the ball.

Iron Man Joe McGinty, a Giant pitcher who had been coaching in the field, grabs the ball as it passes Evers. He runs back into center field with it. On the raised shouts of the aroused Bear Cubs, Chance chases McGinty and wrestles him down. McGinty, doubtless with the effort with which he had earned his *nom de guerre*, heaves the ball back into the crowd.

As the horsehide spheroid spins away into the tumult, we can see sportsmanship, now like some fading invalid, thoughtlessly set aside, hobbling from the scene. Should not have Chance merely shook McGraw's hand acknowledging the Giants won squarely instead of raising this row?[6] Easily, McGinty had no business with the ball. As some contagion, the bonehead play infects first in the destruction of performance, then sportsmanship becomes consumed and the aesthetics of the sport wasted.

Seconds later a ball reappears from Stienfelt, a Cub, and then appears again in Tinker's hand. Whether it was the ball that was hit by Bridwell or another retrieved for dramatic purposes from the Cubs ball bag is almost meaningless. Tinker throws it to Evers who touches second base. Now, there is Umpire O'Day, surrounded by the screaming Cubs, the crowd, and Chance. Was Merkle out and the game yet tied, or had, as in all justice and reality it appeared, the Giants won?

Without crowds, in quiet, law reacts to the bonehead play by the practitioner through sanctions imposed after review by other professionals. Disbarment, suspension, and fines are the tools. Egregiously bad practice produces direct action against the malefactor by the recipient of the shoddy practice. Most easily dealt with by such a system are the worst cases drawn against bright lines: the action unfiled; the defense not pled; the contract lost; the will misdrafted. Publication of punishments occurs to chill a possible offender. Absent formal process or suit,

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6. On September 14, 1987, Phillie Mike Schmidt hit a single to the outfield in the bottom of the eleventh inning with the bases loaded, scoring the winning run. But the Phillies on first and second did not advance to the next base; they left the field. The umpires waited; the now losing Cardinals, however, did nothing. The Phillies returned, sheepishly, and touched the bases without uproar. The loss by the Cardinals reduced their slim lead over the Mets. *Boner Almost Costs Phillies*, The Pittsburgh Press (Sept. 15, 1987).

sometimes there is no sanction save that most indirect economic sanction produced by the marketplace, the refusal to deal with the unrepentant attorney again, or the spread of comment about this less than satisfactory performance.

The lawyer sits in his office, the client's matter unfiled but retainer banked. The lawyer will not engage in formally unethical practices, but how well will he do his job? For greater compensation, he may work harder. Clearly people work for more than money and into the compensation goes all the names of human emotions and divisions about the future and products of the past. In the humdrum, however, compensation is money.

The objective is proper motivation of performance when money does not press enough or when it presses the wrong way. Religious ethics and secular ethical systems with purported universal applications having hence religious tones move men to act for more than themselves, providing spiritual inducement and, when best, that warmth of feeling, the satisfaction of the settled stomach, quiet digestion, the patient love, the clear mind, and the dreamy slumbers made by a job well done. The reality, however, of law's practitioners now is that these traditional approaches to inspiration seem to be too disparate, arcane, or contentious for general application.

And still the money presses hard, perhaps leaning most against those who have the least. Again, not speaking of malpractice but of malpractice's edge, there is the lawyer who makes more money by taking on more cases. The Pardoner's Tale of bonehead play is the complaining small client nagging the small practitioner.[7] Merkle-like errors are wrought through inexperience or inattentiveness produced by either too much to do or by mind-numbing routinization. For a while, the time spent at jobs expands until there is no time. Perhaps this small man will take one more file and cross from the twilight of not doing jobs well to black malpractice. Here is marital discord, violence, drugs, alcoholism, suicide, played out in the grainy ending of your choice.

This *film noir* of decline in lawyer performance due to overload has a comfortable look to those who feel they are not within its very black and white frame. However, no sensible lawyer who practices now cannot but feel the story's chill. While law firm associates grind

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7. *See* Aultman, *Legal Fiction Becomes Legal Fantasy*, 7 J. LEGAL PROF. 31 (1982) (displaying sarcasm, the author examines care and thoroughness, as ethical standards, in the light of how law is actually practiced); *see also*, Cohen, *Confronting Myth in the American Legal Profession: A Territorial Perspective*, 22 ALA. L. REV. 513 (1970).

lives out of air conditioned desperation, lawyers for corporations linger later and later at their posts. The lawyer with the public interest lodged in his heart spreads as thinly as those who seek conventional comfort.

Simpler still is the common experience of choosing time, how much of what quality to spend on a client's task. Within a wide range of performance, as long as the job gets done, you will be paid. For the lawyer at many levels of practice, honestly, with bright eyes, giving of their time, is a matter of some effort, which must be in some measure motivated by an ethical sense.

Participation in sports and educated observance of sports, tempered by the ethic of sportsmanship, might provide some subjected to the toughness of life in the law a taste of that sense. Sportsmanship influences one's own performance for the better and provides a high-toned respect for dealing with your fellows and the game. Further, its tales told do move one to laugh or cry more than some vehicles of instruction because, even if we have only run a race against ourselves to see how fast we could go, we can in the well-told tale feel the wind, the gasp of breath, the thrill, and the satisfaction. Even when we watch, we remember and recreate. Religions make the blood flow and focus attention to the meaningful in life. In the Commonwealth where I live, we lawyers swear our oaths of duty as we shall answer to God on the last great day. While that formulation upon entry to the profession shivers the spine to attention, its effects are evanescent and as this day passes, the last great one seems further away. Sports appreciated, modestly and innocently, is a more immediate and simpler reminder.

Extensive, complex, law-like systems have been developed to insure rule-oriented ethical conduct; however, there is little formal stimulation to work well. While lawyers at lunch rarely discuss performance as an ethical problem, scholars do muse over the improvement of lawyers' performance by improving the lawyers. Lament for the problem is man himself; if man is maggot ridden, how can lawyers be otherwise? Despair is sometimes not fully displayed, concealed by a feint toward optimism. The character of the practicing lawyer can be improved, but not within the law's current structure.[8]

To be familiar with many modern approaches to lawyers' ethics first requires familiarity with a new lexicon. (To be fair, all sports have slang but the terms are often so accessible they become everyone's

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8. *Compare* Postema, *Moral Responsibility in Professional Ethics*, 55 N.Y.U. L. REV. 63 (1980) *with* Fried, *The Lawyer As Friend: Foundation of the Lawyer-Client Relation*, 85 YALE L.J. 1060 (1975).

argot.) These approaches fundamentally question the character of the law itself as creating ethical sloughs, preserving biological, class, race, or mystical stratifications without justification such that practicing law at all as presently constituted seems to be a sinful thing.

A society moved by the acquisitive self-interest of the individual will always be corrupt because the individual is encouraged to act for his own good rather than the good of the whole. Remove the particular incentive, the ability to have more, raise individuals to their duty to the whole, paradise. Now law is rendered too complex. The wealthy control law by controlling the profession, who in turn are those smart enough to do it.

The purpose of that simplification is not to present a scarecrow to fly from or to knock down. Much of what that Marxist paragraph suggests about the origin and operation of the legal structure may be correct. As a solution or inspiration toward legal performance, however, for the mainstream lawyer, proverbs born of Marxism do not now provide guidance for our current non-radical way of life.[9] Further, if law can be practiced by a Marxist without sin, it might at least appear that practicing in a sportsmanlike fashion might be the way.

The people engaged in discussions of lawyers' ethics who are advanced formal philosophers are both elevated and reduced to communicate with poetry. Marxism is merely inaccessible to the unstudied. These works may be hidden in full meaning from all but the devoted. Undeniably, these efforts have pitch and moment and time invested in their contemplation is satisfying and worthwhile. The commonplace criticism of such writings is that it is decorated with concocted words, not Greek, though Greek, not Latin, sometimes English, constructed purposefully imperfectly, half-torn down. Complexity of the writing and emotional response of the reader, between wide points, must be inversely proportional. Wistful and watchful, these caring people have

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9. Many aspects of sporting competition may be anathema to the good Marxist. Importantly, C.L.R. James' book, BEYOND A BOUNDARY (1963), in grand sweep and with a Marxist approach, examines cricket's West Indian development and, to a lesser extent, English sports history of the nineteenth century from which that development was born. James argues that the sport is art and moves men as art does. Further, in the play and practice of the sport, cricket, in spite of its imperialistic imposition on his Trinidadian culture, in spite of its racist operation in his time, there is still taught the valued virtues of restraint, loyalty and effort. Even in America, "It isn't cricket," labels an unsportsmanlike act. James concludes that, if in modern sports the great values are in decline, it is because of general moral decline. "The values of cricket, like much that is now in eclipse, will go into the foundations of new moral and education structures." *Id.* at 190.

hard thoughts to pass to common understanding. Now, their writings are punctuated by poems, so that if the thought is too intricate, perhaps, at least, the verse will show the joy they feel or luckily strike the viscera they must ultimately seek.[10]

If we lawyers do not comfortably talk about personal decisions or religious choices[11] or political theory or language or art, are we bound only to offer a vague "do your best" to inspire devotion to duty and an aspiration toward excellence among our fellows? Law does have lives which are anecdotally and irregularly used for inspiration. Judicial opinions, if displaying sweep, vision, sensitivity, and elegance, can make a hero of their writer. Otherwise, in bulk, they are grey, vaguely important, but still grey mess.

Sportsmanship is useful as a metaphor to stimulate the emotions to the moral conduct of the law.[12] Sportsmanship has a brighter firmament of stars and a blacker hell of sinners, creating the legends and the lives which become the oomph of its simple moral instruction. (Without debate, lawyers must admit their tales lean to the sin side). Sportsmanship requires its adherents to extend themselves beyond minimal standards of performance and to disregard forms of gratification inconsistent with the fair play of the sport. The law wishes its players were so.

Sportsmanship, of course, is an ideal form, the aspect of which is the subject of debate when aficionados gather, applied with the intensity and analytical clarity of any barroom discussion. Its images are omnipresent in our society.[13] There is hardly need to refer to examples

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10. *See e.g.*, Cornell, *Toward a Modern/Post Modern Reconstruction of Ethics*, 133 U. PA. L. REV 291 (1985).

11. Shaffer, *Moral Theology in Legal Ethics*, 12 CAP. U.L. REV. 179 (1982) (arguing that religious responses to legal ethics issues are appropriate, but cautioning on problems of religious plurality).

12. Throughout this essay, it is assumed that sports is of such universal acquaintance that illustration of lawyers' special familiarity is unnecessary. Writing by lawyers on the subject is scant, except with regard to the legal aspects of participation. For example, articles abound concerning legal rights for access to opportunities to play or about tort and criminal liability in too violent events. Nonetheless, in such writing, lawyers, almost inadvertently, display their affection for sport or views on how participation affects human beings. Thus, in arguing whether denial of participation to women in a collegiate setting is violative of a statute, commentators will aver that such denial is precluding women an educational opportunity to obtain the virtues that sports educates: character, citizenship, independence, self-esteem, competitive spirit, comraderie. *See e.g.*, Broder & Wee, *Hawaii's Equal Rights Amendment: Its Impact on Athletic Opportunities and Competition for Women*, 2 U. HAW. L. REV. 97 (1979).

13. While much of our sporting subconscious has been formed from tales of Greece, Rome provides the base slate upon which our laws are written. In the locu-

because, other than the bare bones of outcome, records and technique, the flesh of all sport is how the games are played and talking with others about that conduct. Pete Rose barrels over a catcher, Fosse, in the All-Star Baseball Game. Rose scores in a play of outsized televised violence. An injured Fosse's baseball life thereafter declined. The objection was that Rose acted with too much vigor, given the exhibition nature of the game. The justification is that sportsmanship also requires intensity. The point is that the conversation warms us and some can imagine themselves as Rose, pounding down on the catcher, wildy, not thinking of subleties but only trying to score. Some might stand with stoic Fosse, feeling the common regret of what might have been.

Sportsmanship provides an ethic on how well one must do his job, an ethic which is imprecise but humanly intense. In sports, many masters are served, the sport, the team, the self; but the first ethical test is devotion to the sport. Chiefly, devotion to the sport reflects itself in wholesome effort. In the sporting life, people are still moved when sportsmanship is well practiced and still repulsed when its tenets are breached.

In the Polo Grounds, in 1908, the throng at second base, awaiting O'Day's call, is thrust aside, as the umpires are escorted by police to their private locker room under the grandstand. Many police and mounted troopers were on hand that day as Giants' management had expected a banner crowd. Time passes and O'Day has yet to rule. A few citizens milled about; many had gone home in the happy glow of the delusion that the home team had won. Chance and McGraw fulminate while the umpires huddle behind the door.

What are sportsmen to do; must they wait for the arbiter's call or can, with gallantry, this dispute be settled? That Chance raised the issue, like the lawyer pleading a technical bar to a just debt, does not sit

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tions of the Roman day through the Renaissance, sport might mean a clash of gladiators, the mauling of men by beasts, or the quite popular cat burning. Only through unconvincing rhetoric could these activities be breathed in a sentence with sportsmanship. That violence and inhumanity is lumped as sport does not preclude rescuing the virtues of sportsmanship from the morass of aberrant human conduct. In any case, games of a less purposeful violent nature have been recognized as a good and receive some measure of legal protection. Gorla, *Decision of the Rota Fiorentina of 1780 on Liability for Damages Caused by the "Ball Game,"* 49 TUL. L. REV. 346, 352 (1975) (Italians of 1778 used Roman law to determine that there was no harm in a publicly licit game, even if a party was killed, because the harm was "caused for the sake of glory and virtue").

well with sportsmen. That McGraw did not admit that Merkle failed to complete the play by touching second seems not cricket. Now, like little men, they leave fate to O'Day, in part because he is there, in part because they are professional.

Professionalism is a mutative term, at times and places, pejorative and complimentary. Lawyers embrace the notion that they are professional, which entitles them to the respect of the unwashed. Professions, in the pantheon of occupations, rank highest because they involve a complex body of learning, which requires study and initiation by ancient practitioners, a body too complex to know without the commitment of a lifetime. Law is not the pursuit of the hobbyist. Further, legal professionalism purports to serve a higher good than self and any particular client. The advancement and caretaking of law, together with mumbo-jumbo and real complexity, justifies self-governance by the profession. Self-governance includes the ability to choose who should be admitted to Holy Orders and to judge and punish those who transgress against the rules of the society.

To describe organized lawyers in a sporting motif rather than with monastic metaphor renders the outline of a childrens' game. A sport could start with a child running fast or hopping on foot or making an odd noise. Others join and race or hop in in a way that pleases their eyes or have a shouting contest and, maybe, a fight. Any sort of rule may be memorialized and, in children's games, they are evolving, irrational, vindictive, and sometimes secret. Children are not sportsmen yet and not in full devoted to the aesthetics of the sport, the collective endeavor with personal reward.[14]

To the uneducated in sport's subtleties, a professional is one who is paid for the sporting endeavor, in contradistinction to an amateur, going unpaid. Historically, amateurism, performance for love, has been warmly touted as the way to the virtues sports can offer. Professionalism is the highway to sin, corruption, and degradation of the individual who practices it, the sports that permit it, and the society that condones it.

To the humorless, professionalism in sports is remote from legal

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14. N. CHEEK & W. BURCH, THE SOCIAL ORGANIZATION OF LEISURE IN HUMAN SOCIETY 204-05 (1976) (sport requires highly serious rule observance, first sporadically, then understood for accomplishing collective goals). Sportsmanship cannot be legislated. As a team member, one must develop a sense for the individual as representative of the whole; you must feel that your good name is worth more than a win; do not complain to officials; recognize good play and sportsmanship in an opponent; exercise self-control and fair play. *Id.* at 208.

professionalism. Obviously, legal professionals must have greater backbones because payment for service is the breath of law's practice such that argument about corrupting influences is somewhat off the focus of ethical concerns. Professionalism in the law is criticized in a few aspects. First, the law's complexity, as reflected or compounded by professionalism, enhances the emotional detachment which dehumanizes the practice of law.[15] More simply, being paid to practice might corrupt, in creating tension between lawyer and client and, of course, lawyer and that higher good. Further, lawyering for payment divides legal talent based upon ability to pay. The common view, *sans* revolution, however, is that lawyers should charge for services and, at least in part, remuneration enhances performance.

Educated views on sports history reveal little correlation between professionalism and corruption. Amateurism, as a philosophy, is a romantic concept fabricated in the nineteenth century.[16] Practically, amateurism's supposed virtues or paths to virtue were the specious justification to classify participation in sport by sex, race, religion, poverty and other forms of human condition. Classification by payment detracted from sports development. Performance, excellence in sport, requires, as in law, in addition to talent, a measure of practice. The more time devoted to the enterprise, the better one might become. The poor's time was spent in the pursuit of food.[17] If amateurism was the *sine qua non* for participating in organized sport at a higher level of skill, the poor could not compete and improve the competition. To justify the effect of exclusion of the lower classes, ethical explanations were given that payment corrupts. Further, a history of athletics, the great unpaid Greeks, was invented as a paean to the virtues of amateurism. We are still saddled with this foolishness today.[18]

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15. Simon, *The Ideology of Advocacy: Procedural Justice and Professional Ethics*, 29 WISC. L. REV. 144 (1978).

16. D. YOUNG, THE OLYMPIC MYTH OF GREEK AMATEUR ATHLETICS (1984).

17. *Id.* at 19.

18. *See* R. SMITH, THE RED SMITH READER (1983). Red Smith, in "Amateur Amity," republished from the New York Times, stated as follows:

> As for payola, the Olympic gospel declares that an amateur is one who participates solely for pleasure and for the physical, mental, and social benefits he derives therefrom, and to whom participation is nothing more than recreation without material gain of any kind, direct or indirect.
>
> Nothing could be sweeter than that, or sillier in today's economy. If the groundhogs who administer amateur athletics could face reality, they would discard such tumescent definitions for a simple yardstick: an athlete is a professional if he makes his living at the game; otherwise he is an

Pristine love for sport essentially was unknown to the Greeks at the Olympiads.[19] From the beginning, a firm schedule of prizes were awarded. In fact, artistic competitions, in music and dance, also rewarded the winner with a prize.[20] (We do so still today in contests of art and still wonder whether the prize corrupts the art or the artist.) Often the prize was sufficient to justify a competitor's spending extra time on honing his sporting skills rather than the prosaic needs of life. There was training and there was coaching, anathema to the strident nineteenth century amateurist.[21] Professionals were banned and, in time, formed separate aggrandizements and purveyed their wares. Now, in America, a wide range of sports are practiced with varying levels of payment, the true mercenary, the subsidized amateur, the child in the street, without a noticeable increase in corruption at any level other than in activity to preserve some legalistic amateur status.

While a number of objections have been made to playing for pay by those who play for love and honor, one of the principle objections is that the professional will cheat.[22] Nonetheless in the most popular parlance, *professional*, when applied sportsward, is not a veiled epithet of cheater but is rather (as for lawyers) a sobriquet of stoicism and competence. *Professional* in sport, among professionals, is used with reverence similar to what old barristers might use. In the current colloquy of sport, the term *professional* is used to indicate a toughness, a moral character, a devotion to duty, a wise head, an individual knowledgeable in the trade of his sport. To be the consummate "pro" is one who is a hero, not a cheat.

Legal professionalism requires devotion to the law, a communal feeling among the players of the game, "guided by personal conscience and the approbation of professional peers."[23] Sportsmanship, the virtue of sport, involves honest rivalry, courteous relations and graceful acceptance of results.[24] Simply, acting in sportsmanlike manner

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amateur.

19. D. YOUNG, *supra* note 16, at 7-9.

20. *Id.* The Greeks did not have a word for amateurism. The myth of degeneration of Greek sports due to the onset of professionalism is without support.

21. *Id.* at 48 (anti-professionalism, from ancient days, was focused by a dislike of specialized training); *see* E. GARDNER, ATHLETICS OF THE ANCIENT WORLD 99 (1930) ("Excess begets nemesis; the nemesis of excess with athletics is professionalism, which is the death of all true sports.").

22. Comment, *Consent in Criminal Law: Violence in Sports*, 75 MICH. L. REV. 148, 159 (1976) (economic pressure is such that a professional might do anything to win).

23. MODEL RULES OF PROFESSIONAL CONDUCT (Preamble 1983).

24. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY. Sport is an old word; sportsman-

might meet the measure of the good professional lawyer. Further, the virtues of sportsmanship, although often inarticulable or, if not, spun in sugary terms,[25] are at least emotionally felt. Knowing sport well develops a sense of respect among team and opponents, that lawyers' professionalism, in practice and in development of the law, requires for good effect.[26]

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ship, as conduct or character worthy of a sportsman, is a more recent contrivance.

25. From HORATIO ALGER'S, STRUGGLING UPWARD; OR LUKE LARKIN'S LUCK:

CHAPTER III

RANDOLPH GETS THE WATCH

"It is true," said the teacher, slowly. "Randolph has won the race."

Randolph's face lighted up with exultation.

"But it is also evident," continued Mr. Hooper, "that he would not have succeeded but for the unfortunate collision between Luke Larkin and Tom Harper."

Here some of Luke's friends brightened up.

"I don't know about that," said Randolph. "At any rate, I came in first."

"I watched the race closely," said the teacher, "and I have no doubt on the subject. Luke had so great a lead that he would surely have won the race."

"But he didn't," persisted Randolph, doggedly.

"He did not, as we all know. It is also clear that had he not stopped to ascertain the extent of Tom's injuries he still might have won."

"That's so!" said half a dozen boys.

"Therefore I cannot accept the result as indicating the superiority of the successful contestant."

"I think I am entitled to the prize," said Randolph.

"I concede that; but, under the circumstances, I suggest to you that it would be graceful and proper to waive your claim and try the race over again."

The boys applauded, with one or two exceptions.

"I won't consent to that, Mr. Hooper," said Randolph, frowning. "I've won the prize fairly and I want it."

"I am quite willing Randolph should have it, sir," said Luke. "I think I should have won it if I had not stopped with Tom, but that doesn't affect the matter one way or the other. Randolph came in first, as he says, and I think he is entitled to the watch."

"Then," said Mr. Hooper, gravely, "there is nothing more to be said. Randolph, come forward and receive the prize."

Randolph obeyed with alacrity, and received the Waterbury watch from the hands of Mr. Hooper. The boys stood in silence and offered no congratulations. . . .

26. More corruptive of virtue in the professional athlete (well-paid, numerically few) is an overdramatized work role and an often concomitant flamboyant life style. N. CHEEK & W. BURCH, *supra* note 14, at 212. At the center of attention, players might

The literate extolling of the virtues of athletic competition, both for personal development and societal aggrandizement, antedates any clamor for organized legal bars by several thousand years. Records of any societies which made records measure physical activity, in competition or simply as individual tests, in teams or alone, which mock military[27] or other tasks the group must perform. Of course, games became religious ceremonies as well.[28] In all of these examples, sport was used because, as today, it in fact inspires popular attention and enthusiasm. Spectators (and participants) could wager on outcomes, a practice which seems as humanly fundamental as sport itself or the contingent fee.

Sports history, as the story of governments and wars, courses with

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delude themselves that all of life should have a similar center. Further, fame and fortune provide traditional opportunities for infamy and decline to both lawyers and sports. Modern sports pages erect columns on drugs, but sex is passe. Turkey Mike Donlin, whose leadership of the 1908 Giants was more spirituous than spiritual, fell to the charms of a chorine, Mabel Hite, played his last season that year, hitting .334, and then went Hollywood. Donlin is a rogue who survived, a commonly told story of sports romance but necessarily atypical. The ability to stand prosperity is not just a modern problem.

27. In 1735, William Somerville called sport the image of war without guilt. R. S. Surtees called hunting in 1843, "the sport of kings, the image of war without guilt, and only five and twenty percent of its danger." War games, of course, are common to war's organized practice. Hunting is one of the earliest endeavors classified as sport and the skills in hunting beasts were often the same as those in hunting men. Ghengis Khan, for example, required his Mongols to play the Great Hunt. For weeks an army would encircle an area of up to eighty miles in initial length, tightening the ring. In the shrinking circles, the army was required to drive all animals in its path. None, however, were allowed to be killed and none were allowed to escape. As the ring shrunk, thousands of animals, enemies among themselves, must have attacked the men who, by the rule of the game and respect for Khan, could not kill them. J. CHAMBERS, THE DEVIL'S HORSEMEN 60 (1985).

28. A. GUTTMANN, FROM RITUAL TO RECORD: THE NATURE OF MODERN SPORTS (1978) (religious aspects of sporting events). While modern religious practice has steered clear of sports, five thousand years ago polytheists had no trouble incorporating sporting figures into the pantheon. Greeks and Romans, of course, with a cacophony of gods have a noisome history of such body worship. The Irish mythic hero, Cu Chulainn, a sort of Celtic Hercules, had, as part of his admirable character and his tragic flaw, a tenacious sense of sportsmanship. A monster invites champions to cut off its head so long as it can do the same to the champions the next day. When the monster's head is cut off, it grows back which causes the ordinary champions to flee. Cu Chulainn cuts off the monster's head. When it grows back again, he does not flee but offers his own head for the chop as was the bargain. The monster, of course, does not decapitate Cu Chulainn but proclaims that it was a test and that Cu Chulainn is the greatest warrior in the land. G. HERM, THE CELTS: THE PEOPLE WHO CAME OUT OF THE DARKNESS 242-43 (1980).

males as movers and females cast, at best, as interested observers or tertiary causes. Sportsmanship may cause feminist brows to furrow because of the needlessly masculine cant of the term. Throughout the last few centuries, especially in Great Britain, sportsmanship was used to indicate supposedly masculine virtues. (Often, this brainless cult of masculinity was bound with foolish amateurism.) In nineteenth century Britain, rugby was specifically introduced into the public school system as a way to fortify the Empire's maleness against the foppery of too much education.[29] The Queen needed strong men (not necessarily well-read ones) who were devoted to the team goal and to one another. In the parlance of the day, a sportsman may have been one who gambled, but he played fairly and his heritage was the hunter who rode horses and shot wild game. A sportswoman was a whore.

This history of male idiocy in sports inhibits the use of sportsmanship for the modern feminist lawyer but an effort may still be worthwhile. Nineteenth century notions that precluded women from participation are, properly, stamped upon regularly and sports activity and awareness by women have increased immeasurably.[30] But, all that is attempted to be shown here is an instructional tool, a story. If all cannot now be moved, the story might still be told for some. Importantly, criticism of sports as it is practiced often tracks current criticism of the legal institution. If good sportsmanship is a value which, if adopted, ameliorates sports from its more destructive aspects, perhaps some of those positive traits may be applied to repair faults in law.

For example, a principal feminist objection to the conduct of sport has been that it is infested with an inane male need for competition and dominance, that winning becomes more important than cooperation and performance.[31] One cannot argue that this concern is invalid. Rather, feminist objections may more fully focus on the meaning of

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29. *See* James, *supra* note 9, at 157-68; *see also* E. SNYDER & E. SPREITZER, SOCIAL ASPECTS OF SPORT 107 (1978) (male values or traits associated with sport include aggressiveness, tough-mindedness; dominance, self-confidence).

30. *See e.g.*, Martin, *Title IX and Intercollegiate Athletics: Scoring Points for Women*, 8 OHIO N.U.L. REV. 481, 495 (1981) (Title IX goal is not to improve female performance, but to achieve educational purposes—character, attitude, and good citizenship).

31. For a view that, among feminists, competition in sport can produce a stirring for excellence of general application in life, see Hyland, *Competition, Friendship, and Human Nature, reprinted in* WOMEN, PHILOSOPHY & SPORT (1983) (including historical criticism of competition). *See* E. SNYDER & E. SPREITZER, *supra* note 29, at 119 (since the 1920s, various women's educational groups have argued for increased athletic participation to foster "health and good citizenship").

sportsmanship. Proper sportsmanship would clearly hold that dominance and winning is not preeminent. Sports can still have instructive purpose. The virtue is sound but the players have been frail.

In law, this tension between result and method, between winning and how the game is played, the adversary system also has been hounded but not treed. In the human endeavor, elimination of the tension may require a better breed of person or an improved moral scheme than that which might be molded through love or instruction. Sportsmanship, at least, requires a sensitivity to the matter which may improve the state of the lawyer, regardless of sex or style of practice.

While cheating in sports comes not necessarily from its male history or from the possibility of lucre, it nonetheless occurs. Cheating to win implies an understood set of rules. Understood is the essence of play, one with another; rules are agreed and known to the players. In a real sense, too, sports in which only one participates still has a body of rules which promotes the firm qualities of the activity. Without racing against another, a runner runs, but feels guilt if distraction lets him trip or if a corner is cut from his discipline. He has cheated himself. Children playing readily adopt sets of rules often complex and instantaneously amendable for their play but even a violation of the lightly considered laws produce cries of "cheater."

Two types of cheaters emerge, the fraud and the adept. Some cheating occurs through fraudulent activity outside the skills of the game; some, through use of enhanced skill at the game. Stealing Monopoly money is fraud, but heating golf balls or loading a spitter allows an adept an edge to use his skills.

Sports stop cheaters as the law does, with referees and sanctions. Ejectment, suspension, and fine are the formal remedies of the highly organized sport and, with proper color, the law. Children eject, too, and suspend. (Perhaps, the sanctions of children are not so severe as the cheater in yesterday's sport can redeem himself through cooperation in today's game.) As with the law, however, such sanctions are imposed only upon public discovery and, in a sense, proof. Often the adept cheater cannot be caught with the red hands required for formal action. Further, there might be a feeling in both sport and the law that complaint about a cheater in the formal fashion is in itself unseemly. Simply, public bruhaha about cheating reflects ill on the accuser's sport (the law) as well as the accused.

Emotions leap high, the blood pounds, when a sportsman confronts a malefactor. The best way to defeat cheating, meaning the most satisfying for the sport and the sportsman, is to defeat the cheater. While, ostensibly, lawyers are reluctant to judge on happenstance, hearsay, and conjecture, a sportsman (whose mind may not be inured to judgment and is not trained to constant doubt) will recognize and deal with a cheater whose malediction is not readily the subject of sanction. Beating him at his own game is contemplated like the hot dog, with relish; superior skill or heroic effort will be used to defeat the cheater.

Beating him at his own game could also imply cheating to defeat the cheater. Under the supervising theory of sportsmanship, such conduct must be looked upon as unjustified. This urge to respond in kind seems to grow when violence exceeds the accepted level of play.[32] Beaning the "bean ball" pitcher or goring the hockey goon is rough justice, but is advocated by some who, as with law, must believe that there is justification for severity in return. Such anarchy, however, is, in part, temporary or, at least, cyclical. Cheating, undeterred and undefeated, or responded to by further cheating, results in the destruction of the sport or results in the creation of different rules, a new sport.

Cheating in sports, as well as shoddy performance, its banal sibling, is also dealt with by shame. A cheater in sports suffers ostracism, reprobation, invective, ridicule, derision. The response can be quiet, silent in fact, or with the bass tones of a booing crowd. Here is how performance is most subtly affected seemingly without regard to economic incentives. Cheating is evil not only through contravention of the ways of a particular game but through contravention of the notion of sportsmanship which cuts across all sports and is the base of the mutual understanding required to conduct an aesthetically pleasing contest. The fans will whistle and hoot at the violator uncaught by umpire's net. Even teammates, under sportsmanship's view, should abandon the cheater. The shoddiest performance of all is not the adept cheater, but the lackadaisical player, the one who fails to give all.

After games grew from violent enterprises where death told of the defeated, the neutral observer, the embodiment of truth telling and ob-

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32. Comment, *Compensating Injured Professional Athletes: The Mystique of Sport Versus Traditional Tort Principles*, 55 N.Y.U. L. REV. 971, 981-82 (1980). While sport fosters good health, channels aggressions, improves self-image, and encourages discipline and a team feeling, professionalism encourages violence, at least through an establishment of stars who have such a reputation. *Id.* at 974; *see id.* ("The socially approved ideal of sportsmanship and fair play would be better served by providing redress for deliberately or recklessly inflicted injuries while still allowing professional team contact sports to be played vigorously.").

servation developed. Umpires have an ethic to be blind as justice but sharp-eyed as envy. This ethic is a heightened sportsmanship whose hallmarks are impartiality, imperturbability, devotion to the game, and attention and care without the emotional confusion of loyalty to team or place. Their presence, however, is not simply to guard against malediction by participants who are moved to cheat because competitive urges to win raise a lust above love of the game. More importantly, umpires free the players to act with abandon so that, in cooperation, the play of the sport is enhanced.[33]

The existence of a neutral observer whose job it is to arbit winners and losers may be suggested as the cause of the loss of some measure of childlike sportsmanship among the players. I will not call myself out because the umpire should. If he misses the call to my advantage, fine. In the cloudy netherworlds of the soul, human beings create ambiguities which provide moral comfort while they are in the process of abandoning the responsibility of virtue. If the umpire said I was safe, maybe I was. This clutch at a chance in the mists is common in the practice of law, where rationalizing the improbable into the possible allows the advocacy of the marginal. After all, the judge would decide.

Cynics might suggest the official presence is a natural consequence of professionalism. Since money is on the line, sportsmanship leaves the field, and the umpire holds the stakes. The umpire's presence allows the players to release the ethic that made the child's game and to act on the margins of propriety. Thus, in games of competition, the players, if their primary objective is to win, may take more time exploring perhaps an easier road to success through dubious conduct or cheating than in honing the more difficult skills of the game.[34] Such practice too would inhibit the development of good play.

The vile word is still competition. In sports, it is treated by its critics as a disease, creating violence, ill will, racism, all the worst in man. More charitably, the competitive aspect of sport may be described as giving an outlet to this evil animism.[35] One of the salutary effects of

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33. Comment, *supra* note 22, at 174-75. While emphasizing sports as an outlet for aggression, this commentator argues that policing through immediate on-field referees reduces outrageous behavior more effectively than tort or criminal sanctions.

34. Hiller, *Language, Law, Sports and Culture: The Transferability or Non-Transferability of Words, Lifestyles, and Attitudes Through Law*, 12 VAL. U. L. REV. 433, 448-55 (1978). American emphasis on winning, as opposed to winning a moral victory as in cricket, contributes to client view that lawyer will stretch the laws. *Id.*

35. C. ROJEK, CAPITALISM AND LEISURE THEORY 165 (1985) (sports is a mimetic phenomena, "where intense emotions are released in a controlled form").

participation in sports is supposedly that an outlet for these primal tendencies is provided in a contained fashion. Sports is civilizing, collective, and a palliative to controlling extreme behavior.

Lust for victory, a vice when corruptive of the virtue of sport, tempered, is also virtue, that which makes the competition. The athletes opposed, trying their best, strengthen each other through contest. Of course, the same virtues and vices attend the law, which is a competition both in abstract and practice. Litigation or negotiation are familiar in competitive aspects. Clearly, too, philosophies of law are built on such notions; the law puts an idea against another, hopes for honest strong advocacy on both sides, to produce before a wise head a display of as much clarity of thought as the human mind can create and take.[36] Which idea eventually wins, it is taken on faith, is the one that should win. There are temporal dislocations in which bad ideas prevail but the faithful believe, through the work of the system, the bad will be put out in time. This is a game of inches.

The two clubhouse lawyers waited, Chance, appealing to law, that Merkle had not touched second base, McGraw, calling for equity, that the game had been fairly won. With some daylight left, O'Day and Emslie emerged from chambers and ruled; the game was declared a 1-1 tie. The jurists hurried away.

A short analysis of O'Day's ruling shows how judiciously a yet unrobed umpire might act. There is in baseball no such thing as a tie; yet he called this game one. In baseball, in 1908, the game was played through extra innings, until a team finished ahead. If light, time, or blue laws stopped play, the game may be suspended and restarted. If the home team cannot provide a place to play, the game is a forfeit. Clearly nervous over health and welfare, O'Day must have concluded that a resumption of the game in such riotous circumstances would have been unwise. Chance argued later that, by the time the potentates had emerged from their confab, the scene was serene. Many of New York's finest remained to clear away riffraff. Chance further thought that, if New York could not clear the field, then the Giants had forfeited the game to the Cubs.

It is unknown whether all these thoughts crisscrossed the umpires' minds. One thing is certain: they knew the National League schedule and standings. Both teams (and Pittsburgh, too) had about two weeks of games left. The pennant race was likely to be decided by those

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36. Fuller & Randall, *Professional Responsibility: Report of the Joint Conference*, 44 A.B.A. J. 1159 (1958).

contests. The game, to avoid violence and uproar, could for now be left undone.

The consequence of the bonehead play was acrimony and, after a fashion, litigation and prevarication. The Giants want the win; the Cubs want the win. On September 24, 1908, President Pulliam of the National League upholds the umpires' ruling. He rules that there is no open date before the season's end, so the game would not be played off. Appeals are filed, first to President Pulliam, again, then to the Board of Directors of the National League. Lawyers are employed, written reports are prepared by the umpires and participants. The Giants took depositions from fans.

Where was Merkle? Majoritarian history places him in the locker room, too far from where he should have been. The Cubs and Giants elicited tales that filled the press with fiction and bile. Christy Mathewson, a pillar of rectitude, morally crumbled with the heat of the dispute to say he had stood arm-in-arm with Merkle, well before any ball had arrived, on the powdered pillow of the second sack before sedately retiring with his friend to the clubhouse. The Cubs said they saw Merkle being dragged from the clubhouse by Turkey Mike Donlin, rake but team leader of the Giants, in a vain effort to reach the bag before the ball. Some said O'Day did not see the play; some said he was bribed. A giant Giant, Fred Snodgrass, said Merkle went into the clubhouse and many wistful fans knew, in their hearts, Merkle had made the mistake. Almost immediately, the play was described even by advocates of the New York team as bonehead.

By October 2, however, the *sub rosa* hope of all, that the game would not matter in the standings, had been slowly evaporating. The Giants lost five games, three losses coming every other day in a single week to the lowly Phillies and a young pitcher, Harry Coveleski (known afterwards as the Giant Killer). On October 2, Pulliam reaffirmed his position, with the Giants now in second place. He said:

> Much as I deplore the unfortunate ending of a brilliantly played game as well as the subsequent controversy, I have no alternative but to be guided by law. I believe in sportsmanship, but would it be good sportsmanship to repudiate my umpires to condone the undisputed blunder of a player?

On October 5, 1908, in as electric an atmosphere as sports can generate, in a clime in which baseball gripped new numbers with passion, Pulliam met in New York City with the Board of Directors of the league, Herrmann of Cincinnati, Murphy of Chicago, Dreyfuss of Pittsburgh, Ebbets of Brooklyn, Dovey of Boston. The litigious Murphy was immediately booted from the meeting because of self-interest. Dreyfuss was also ruled out for if the Giants were awarded the game, the Pirates might yet tie for first. The season was to end on October 7. Barney Dreyfuss objected to his ejection as he said he was an honest man. He said he would have gone the Cubs' way anyway. The board upheld Pulliam who had upheld O'Day. The game was a tie. The only fair thing was to play the game over, if necessary. On October 7, 1908, the Giants won their last game to tie the Cubs for first place. Now, to replay that game that had ended with blunder had become necessary.

Obviously, good performance on September 23 would have won the game for the Giants. But what of the conduct of these people after the error: denial, dispute, acrimony? Sportsmen do not behave thus. Merkle said he went to second but not often and with no stridency and certainly no conviction. The great confluence of social events and chance put Merkle's bonehead play at the center of public attention for examination and ridicule. Running into the dugout early in June may have raised McGraw's ire and would have been noted in passing humor by the tough sporting press. Now, the young man must have been forced to the point of ruin as the world's weight pressed him down. An error which hurts the team so badly in sport mortifies, but sportsmanship requires the recognition of frailty in us all. After all, the pursuit is engaged in to brace the virtues which, without fanning, flicker.

Merkle, the rookie, sat in the dugout on October 8, 1908, as the Cubs returned to Polo Grounds to play that game again. Tanney, the regular, was back at first base. Merkle hoped for a Giants' victory that would erase the flawed game, dim the taint, and loosen the grip of his bonehead play. Pfiester started the game anew for the Cubs, Matty pitched for the Giants. Bill Klem was umpiring behind the plate.

Fred Snodgrass says that Iron Man McGinty tried to pick a fight with Chance to get him ejected from the game. Chance, as important to his team as a player as he was as Peerless Leader, would have none of it. The game was closely fought but, for Merkle and the Giants, not won. Mordecai Peter Centennial Three-Fingered Brown, pitching in relief, won for the Cubs, 4-2. Merkle was 19 years old.

Decisions about what is right, wrong, sporting, cannot be made easily or, at least, those decisions which are easy are the least stimulating. Chance took a game fairly won through enforcement of a technical rule violation produced by a rookie error. Chance did not think twice, and while one may argue whether he should have been remorseful, he was not. McGraw sputtered, attempting to conceal an error which he must have known was made or which, through lawyer-like subconscious trickery, he convinced himself of arguable doubt. The Cubs were right to call the rule but the Giants had won the game. What should be engendered by this display is not the rectitude of one position over another but rather the intensity with which these issues are felt. Unless we feel a difference in conduct, not measured by wins, losses, not whether the rule exists or not, improvement in ethical performance will be cursory, insubstantial, and weakly formal.[37] This emotion must be brought to the practice of law.

The bonehead play carried a sentence to Merkle, beyond lifetime imprisonment, beyond the grave, about his quality and character. Great tales, too, should have a spiritual quality, touching the human in us not only with the exaction of punishment against the evildoer, but also the bright light of redemption for the sinner.[38] For President Pulliam, his sentence was death. He, too, must have hoped that the Giants would win the replayed game so that roughly sensed justice would prevail; but, perhaps, the Cubs were right. Back and forth his mind must have gone for who is right and wrong. Both sides assailed him throughout the winter and spring. On July 19, 1909, in depression, he committed suicide.

Angry, gloating Chicago, champions of the National League, played in the nascent World Series following their victory. Chicago beat the American League Detroit Tigers. The Fates bob and weave. Here is

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37. Hiller, *supra* note 34, at 444 ("If one watches the British long enough and carefully enough, he will notice a more than coincidental connection between their respect for the law and their cultural preoccupation with sports—with playing the game according to the rules.").

38. In his great essay, "The Fight," Hazlitt recounts the tale he was told by a gentleman from Bath concerning his conversation with a great fighter, Stevenson:

> 'I asked him if he had ever beat Broughton? He said Yes; that he had fought with him three times, and the last time he fairly beat him, though the world did not allow it. When the seconds lifted us up in the last round, we were so exhausted that neither of us could stand, and we fell upon one another, and as Master Broughton fell uppermost, the mob gave it in his favor, and he was said to have won the battle. But . . . the fact was, that as his second (John Cuthbert) lifted him up, he said to him, 'I'll fight no more, I've had enough;' which, "says Stevenson," you know gave me the victory. And to prove to you that this was the case, when John Cuthbert was on his death-bed, and they asked him if there was anything on his mind which he wished to confess,' he answered, 'Yes, that there was one thing he wished to set right, for that certainly Master Stevenson won that last fight with Master Broughton; for he whispered him as he lifted him up in the last round of all, that he had had enough.' " 'This,' said the Bath Gentleman, 'was a bit of human nature.'

irony and rougher justice: Chicago has not won a World Series since 1908.

What of Merkle? Al Bridwell, his teammate, made a teammate's response, that these things happen. Bridwell, who hit the ball that sent Merkle the wrong way, in the quiet of aged retrospection, considering the abuse Merkle suffered, said he wished he had struck out. There is a sportsman.

Although eighty years later, with only the reprobation, bonehead, tied tightly to Merkle, we might guess that his professional career ended with that single act of inattention. But, as sin is inevitable, for salvation to be possible, redemption must sometime occur. Inspiring tales do not display the faults of men, then cast the man hopelessly into an abyss. Even Goethe contrives an end for sinful Faust, redeeming him on the slender thread of love. Merkle, among his peers, was also so redeemed. As a member of a crackerjack Giants' infield for years to come, he often sat at McGraw's side. Saddled with that derisive label by the unthinking, his fellow sportsmen saw the human frailty well and the worth of the individual in his spirit to overcome.

Perhaps, at last, it is in this redemption that the play of sports with sportsmanship offers the most value for the education of the lawyer. Lost, now in the mass of pursuits and interests we represent, antagonistic sometimes, unrelated at others, is the sense that all lawyers, at least in theory, do have common goals and are deserving of common respect. Without effort and respect, the law cannot achieve any theoretical goods. Lawyers must have inspiration from the whole of life, rather than simply from abstractions of law, to act with sacrifice and vigor. For some, this inspiration can come from sport.

Mediation: Try It, You'll Like It.

Magistrate Judge Leo I. Brisbois
U.S. District Court
Duluth

Chief Judge Thad J. Collins
U.S. Bankrutpcy Court - Northern District of Iowa
Cedar Rapids

John R. Stoebner
Lapp, Libra, Thomson, Stoebner & Pusch, Chtd.
Minneapolis

Judge Katherine A. Constantine, moderator
U.S. Bankruptcy Court
Saint Paul

Mediation

Magistrate Judge Leo Brisbois, Bankruptcy Judge Thad Collins, Bankruptcy Judge Katherine Constantine, and John Stoebner

- Goals of presentation:
  - Inform lawyers with no experience in mediation
  - Improve skills of lawyers with mediation experience by providing new considerations
  - Provide three different perspectives
    - Bankruptcy judge
    - Magistrate judge
    - Lawyer
- Who?
  - Which mediator?
    - Bankruptcy judge
    - Magistrate judge
    - Private mediator
  - Which parties?
    - Everybody?
    - Pro se?
  - Required
    - Persons with authority to fully resolve dispute and their counsel
    - Confidentiality—unless mediator authorized to disclose
      - Between parties
      - From presiding judge
- What?
  - Varies case by case
    - Mandatory
    - Consensual
  - Free—unless private mediator hired
  - Means for parties to exert control over the outcome
  - Flexible approach to settle conflicts
  - Flexible scheduling and time commitment
  - Example of a typical bankruptcy judge mediation
- When?
  - Is mediation appropriate in all cases?
    - What about “all or nothing” cases?
  - If it is appropriate, at what point should a case be mediated?
    - Tension between usually saving money and preparing for trial
      - How early in the case?
      - Pre- or post-discovery?

            - Pre- or post-summary judgment?
        - Considerations:
            - Amount in dispute
            - Strength of the case
            - Complexity of the case
            - Type of dispute
            - Desire to end litigation now
- Where?
    - Anywhere, however:
        - Generally conducted in courthouse if judge mediator
        - If the parties are far-flung or the judge is out of district, or if a private mediator is engaged, the mediator may travel
- Why?
    - Statutorily supported
        - Fed. R. Civ. P. 16(c)(2)(I) and comments
        - 28 U.S.C. § 651(b) requires each United States District Court to authorize alternative dispute resolution processes "in all civil actions, *including adversary proceedings in bankruptcy*"
            - D. Minn. LR 16.5
            - BKY LR 9019-2
    - Numerous benefits
        - Control over outcome
        - Usually reduces fees and costs
        - Allows attorneys and clients to identify/understand strengths and weaknesses of their case
        - More control over timing
- How?
    - Various methods
        - Shuttle diplomacy/facilitative
        - Advisory/evaluative
        - Quasi-adjudicative
        - Joint and/or separate sessions
    - Tips
        - Read the mediation order and follow the instructions
        - A mediation statement should tell the mediator what they need to know and include the last offer and who made it
        - Know the law and facts surrounding your case
        - Be prepared to give an "opening statement" in a joint session if counsel and the mediator believe "opening statements" would be productive
        - Prepare potential settlement structure(s)

Ethics: Improper Attorney-Client Relations – Sex with Clients (and Other Really Dumb Things to Do)

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Sex with Clients

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These materials are no substitute for listening to my talk, *Sex with Clients*. For those too ready humorists, the talk has no pictures. Talk is talk, just talk. The lawyers burdened by continuing education of the ethics sort always listen. The topic, after all, is sex with clients.

In this short writing, I will parse the rule in its American Bar Association Model Form, Rule 1.8(j). (I have attached to this piece the pertinent provisions.) The rule itself is within the model paragraphs on conflicts and is a product of the chapters and verses on lawyers' conflicts with clients. While Rule 1.8(j) draws an unseemly clear line — a lawyer may have sex only with potential clients —, Rule 1.7, the general conflicts provision, draws a loose border. Lawyers wonder where the border is, in all matters. And, to put the problem as one of romance, when does the lawyer's interest, perhaps love interest, create a "significant risk" of a material limitation on the relationship?

Ordinary conflicts, meaning unromantic, are tested this way. If the conflict exists, the lawyer must notify the client. If the lawyer thinks that the conflict can be overcome by the lawyer's virtue and the client is so persuaded, the relationship may continue.

Treated as text for ordinary legal worrying, the rules offer an opportunity for doubt. Is there a conflict in the first place, is it now, is it over, is it yet to come and might not ever? Is it big enough, is it rough enough? Do I tell them? What do I tell them?

I interrupt this lawyers' anguish to suggest that lawyers' confusion about this rule is exacerbated by our culture's attitude toward the rule. Lawyers actually answer the first two questions, no. And, ala a tawdry affair, decide to tell the client nothing. If telling them comes to pass, the further question, can I be competent in spite of it, becomes an easy one to answer yes.

The experience with sex with clients, as a rule, is a fable of sorts that may deal with a special corner of evil, yet provide instruction about the larger story of conflicts. The experience of sex with clients as a talk is part of this story, if only to tell the story of lawyers' belief in the fable of love.

The early development of the talk was occasioned by the prospect of continuing education box office. My state, the Commonwealth of Pennsylvania, came to mandate continuing education in the early 1990's. The Quaker State trailed many jurisdictions in C.L.E. by a decade. Ethics education in C.L.E. is and was regularly mandated in a proportion far more than its weight in a law school curriculum, let alone legal practice. Several states, like ours, mandated only education in ethics in their start-up years. Now, Pennsylvania requires two of twelve hours annually, with many jurisdictions with similar requirements.

At the start, now twenty plus years ago, the creation of a useful, not boring ethics hour for practitioners, was difficult. Ethics law and lecturers were hard to come by, knowledge, if any, was produced from the litigators' experience. Most lawyers, however, do not ply that trade and even if they do, recounting the cautions and sins in their efforts grew rapidly stale. I created *Sex with Clients* to attract clients to Duquesne University School of Law and its nascent effort to sell continuing legal education. Consequently, *Sex with Clients* was first delivered circa 1995. Then, on average more than once a year since then, to groups large and smaller around the country, to lawyers general and specific. *Sex with Clients* has been requested. When I am asked in the ethics C.L.E. game about topics, I have, in response, suggested more than a few. When I offer *Sex with Clients*, lawyers almost always take it.

Without citation, I will say sex sells. When I talk I always allow the group to bowdlerize the title. I have offered to style the talk as "*Honor in the Profession*." The description, however, always promises sex with clients.

In this writing and while I talk, I caution that the reality of the tales of sex with clients is not just sordid, but degrading horrors of predatory behavior. Before the CLE boom in ethics for all, family law associations offered programs on the subject. In those days, in towns large and even small, lawyers all knew of a divorce lawyer who had impregnated a client while also handling her divorce. The pronouns here are purposeful. Not without exception, but sex with clients brought to mind the male lawyer, the female client, the divorce or soon to be one. These stories are not titillating, prurient, or erotic. These are not love stories. They are not funny.

Sex with Clients is in some measure an ethical confidence trick, a play with words that might capture the conscience. Before I talk, as best I can, I mingle with the crowd. Before the event, of course, there has been interchange with organizations, administrators, and other poohbahs, about topic, title, time, tenor. My materials (until this piece) were a bare bones, skeletal outline of the rules of the age, a few case sketches and some bar association opinions. Purposely light and generic, they traveled well enough, as did I, to a gross of jurisdictions, broad based groups and narrow practice niches, audiences with national license, to Inns and outlying counties.

In these pre-talks about the talk, I was always frank that my thesis was, as I have set it out above, and this matter is serious on its own. I immediately confess that there will be much laughter, belied by the old scant materials. But I also offer that I hope to make you feel guilty for laughing. At this point, someone asks "Will there be PowerPoint?" The someone chuckles and maybe another someone with him. And, yes, again, a him. No, I reply and note that I have heard that bon mot every year since PowerPoint was invented.

What is so funny about sex with clients? Here is the trick; we tell ourselves stories. If you do not know sex with clients, it might become the image of imaginary fun, French farce, erotic pictures, en flagrante delicto. Not a real problem at all, perhaps like ordinary conflicts of interest.

Formal state law restrictions on sex with clients began with more vigor in the early 1990's. State supreme courts, the ne plus ultra of discipline, offered opinions (not rules) that restricted sex with clients in the family law setting. <u>See In re DiSandro</u>, 680 A.2d 73 (RI 1996). Here the sanction was censure. A.B.A. FO 82-364 analyzed the problem as one of conflict, a relationship fraught with dangers perhaps, but not so unworthy as to be banned. More than a few criminals had sex with defense attorneys that did not raise, apparently, issues of ethics but rather claims of ineffectiveness of counsel. <u>See Neelley v. State</u>, 642 So.2d 494 (Ala. Crim. App. 1993).

Some state supreme courts did engage in positive rule making, bucking the model, prohibiting sex with clients. Local conditions that do not appear in public pronouncements may have led to these decrees rather than part of a national movement of revulsion. Chatting with the locals in Wisconsin, Oregon, and West Virginia, three of the handful that pre-date the A.B.A. rule, I found each court motivated by spectacularly bad behavior, serial and exposed. At least, this intelligence was offered by the bar and often confirmed in the public press.

In the A.B.A. Ethics 2000 Project, the rule, again, 1.8(j) arose. Prior to the addition of the prohibition, such as it is, I talked about the wisdom of blanket restraint. Licensed professionals (other than ours) have long banned sex with the objects of their duty: medicine, education, social work, military. To what end do we quibble about whether the intimate relationship is a material impediment to legal judgment? The quibble becomes more offensive when the simple solution is to withdraw. But, of course, there was consent, true love, no harm, and broken hearts are the natural consequence of blooms falling off roses.

Lawyers have told me, in those days, that they agreed with me on a ban but they never would have met their second wife if they had not represented her in her divorce. Now, of course, absent that unlikely “pre-existing sexual relationship,” the lawyer would have to choose between the lady and the fee.

The rule had some subtleties. The conflict produced by sex with clients is personal to the lawyer. Unlike virtually all other types of conflicts, this one does not result in firm wide disqualification. The term “client” here, as elsewhere, has an indistinct border for those representing entities, wondering whether romance with the humans in the control group is off limits. Increasingly, lawyers must be reminded that non-lawyer assistants are subject to the rule as well. Lawyers must seek to educate and prevent all those they supervise from doing what they cannot. The paralegal’s fresh sex romp with the CEO must be stopped by the corporate law department. Perhaps in a sexualized culture, it is quaint to say that relationships, short of sex, can still create intensity that can shake a lawyer’s cold independent judgment into a conflict between love and law.

The law of conflicts is naturally blurred as the nature of conflict itself is infinite. All stories told require conflict. As the literature professor would say: man against nature; man against man; man against himself. Conflicts in law are produced by man (the lawyer) against nature, if one takes nature, as the elements, as the environment of practice. Even a hero may be doomed to fail for want of a nail, a horse, a match. Oedipus comes to a bad end because of the failure to disclose a conflict. Nature includes deities like God or gods or judges or fortune or fate (also like judges).

Man against man is where two interests are antithetical. In narrative, we root for one man and against another. Reading decisions on conflicts, one might find the quest for a rooting interest hard. You may of course have a view as to how these stories ought to come out, a view tinged by personal interest and experience.

Modern storytelling, since *Hamlet*, is much about man against himself. I am ill equipped to offer a survey of such literature or a Freudian explication. I will note that many ethical rules have been produced in response to judgments about human nature. Ethical prohibitions have been justified by the belief that certain situations are too tempting of sin or are too likely to be perceived as too tempting of sin.

For sins, ethics and conflicts, you cannot beat sex. The new model rule created more discussion and controversy than many other changes, as states examined the new model rules in consideration of changes to their real rules. More upset was evidenced for this minor inhibition on romance than on such serious issues as multijurisdictional practice, permissive revelation to prevent financial harm and screening. In part, one may say that the protests of the bar were in defense of true love. In part, the protests may just be evidence of lawyers' dislike of conflict analysis because, in their clouded hearts and minds, they believe they can overcome any temptation to ineffective representation.

Conflicts can arise from infinite permutations and, unexpectedly, just as love and sex. Often, lawyers see no conflicts, no trouble ahead, the same cloudy vision that comes with love and sex. And the lessons of conflicts, repeated over the years, still have only slightly dimmed the temptation to sin and error, just like love and sex.

Section 365: Key Issues for Creditors and Debtors

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Section 365: Key Issues for Lessors Under Non-Residential Real Property and Personal Property Leases

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I. THE DEBTOR'S DUTY TO PAY POST-PETITION RENT

A. Non-Residential Real Property Leases

1. Types of Rent Payable Under Non-Residential Real Property Leases

In a standard "triple-net" lease of non-residential real property, the tenant agrees to pay monthly rent to the landlord, as well as real estate taxes, insurance and common-area maintenance ("CAM") charges for the property. Typically, the tenant is required to pay a minimum amount of "base rent" on the first day of each month during the lease term. All other amounts due to the landlord (real estate taxes, insurance and CAM charges) are considered "additional rent" payable at the times set forth in the lease.

In most cases, the tenant is required to pay real estate taxes when the taxes become due to the county (typically twice per year); insurance is due when the payment is due to the insurer (typically annually); and CAM charges are paid monthly based on an annual estimate that is determined at the beginning of each year. At the end of each year, the landlord and tenant reconcile any underpayments or overpayments of estimated charges. This results in either a payment to the landlord or a credit to the tenant to be applied against other obligations due under the lease.

In shopping malls and other retail situations, a tenant may also be required to pay "percentage rent" to the landlord based on a percentage of the tenant's gross sales.

2. Section 365(d)(3) - The Debtor Must "Timely Perform" All Obligations Arising Under the Lease

Section 365(d)(3) of the Bankruptcy Code provides, in relevant part:

> The trustee *shall timely perform all the obligations of the debtor … arising from and after the order for relief* under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period.

11 U.S.C. § 365(d)(3) (emphasis added).

In the Eighth Circuit, the controlling case interpreting this section is *Burival v. Roehrich (In re Burival)*, 613 F.3d 810 (8th Cir. 2010). In *Burival*, the debtors' payments for leased crop land were due on April 1st and December 1st of each year. *Burival v. Creditors Comm. (In re Burival)*, 406 B.R. 548, 550-51 (B.A.P. 8th Cir. 2009). Because the debtors filed their Chapter 11 bankruptcy case on November 29, 2007—only two days before a large rent payment came due—nearly all of the December 1st post-petition rent related to their pre-petition use of the property. *Id.* Nevertheless, both the Court of Appeals and the Bankruptcy Appellate Panel held that Section 365(d)(3) is unambiguous and required the debtors to pay the full lease payment when it became due, without proration. *Burival v. Roehrich*, 613 F.3d at 812-13; *Burival v. Creditors Comm.*, 406 B.R. at 553-54.

Under *Burival*, Section 365(d)(3) is a "bright-line rule" requiring the debtor to perform all post-petition, pre-rejection obligations as they become due, with no need for proration. *Id.*; *GE Capital Commercial, Inc. v. Sylva Corp., Inc. (In re Sylva Corp.)*, 519 B.R. 776, 780 (B.A.P. 8th Cir. 2014) (stating that Section 365(d)(3) requires the debtor "to timely perform all post-petition obligations of the debtor under unexpired leases until such time as the lease is assumed or rejected"); *In re Sky Ventures, LLC*, 523 B.R. 163, 167 (Bankr. D. Minn. 2014) (describing Section 365(d)(3) as a "bright-line rule" requiring the debtor to "perform all post-petition, pre-rejection obligations as they become due, with no need for proration").

Accordingly, in the Eighth Circuit, like other "billing date" jurisdictions, a debtor must pay *in full* all liabilities that arise post-petition under a lease of non-residential real property when they become due, even if they relate to pre-petition events. *Burival v. Roehrich*, 613 F.3d at 812. *See also In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 206 (3d Cir. 2001) (stating that "an obligation arises under a lease for purposes of § 365(d)(3) when the legally enforceable duty to perform arises under that lease"); *In re Valley Media, Inc.*, 290 B.R. 73, 76 (Bankr. D. Del. 2003) (concluding that, under Section 365(d)(3), a debtor must pay the full amount of a property tax payment coming due post-petition, even though the tax accrued pre-petition).

Further, under Section 365(d)(3), the debtor's duty to timely perform its post-petition obligations applies "notwithstanding section 503(b)(1) of this title." Under this language, the debtor is required to timely pay all post-petition rent to the landlord prior to assumption or rejection, regardless of whether the debtor is using or receiving any benefit from the property. *See Burival v. Roehrich*, 613 F.3d at 812-13; *Burival v. Creditors Comm.*, 406 B.R. at 555. If the debtor fails to pay these amounts to the landlord, Section 365(d)(3) gives the landlord a priority administrative expense claim for all unpaid amounts due, without the need to satisfy the requirements of Section 503(b)(1). *Id.*

3. <u>"Stub Rent" – Administrative Expense Claims Under Section 503(b)(1)(A)</u>

Leases of non-residential real property frequently require tenants to pay rent in advance at the beginning of each month. In these situations, it is not unusual for rent to become due pre-petition, but relate to the tenant's post-petition use of the property (the opposite of what occurred in *Burival*). The rent owed to the landlord for the tenant's use of the property from the petition date through the first of the following month is commonly referred to as "stub rent."

Courts disagree on whether Section 365(d)(3) requires a debtor to pay stub rent. Where a debtor's obligation to pay its rent arises prior to bankruptcy, courts following the "billing date" approach hold that stub rent is not payable under Section 365(d)(3). Other courts, following an accrual or "pro rata" approach, require a debtor to pay the portion of the monthly rent that relates to its post-petition use of the property. *See Burival v. Creditors Comm.*, 406 B.R. at 552-53 (describing the disagreement among courts on how to treat stub rent under Section 365(d)(3)).

As described above, the Eighth Circuit is a "billing date" jurisdiction, so stub rent is not recoverable under Section 365(d)(3) where the liability to pay the rent first arose pre-petition. Nevertheless, even "billing date" courts generally agree that a commercial landlord may rely, instead, on Section 503(b)(1)(A) to assert an administrative expense claim for unpaid stub rent, if the debtor uses and benefits from the landlord's property. As described by one court:

> There is no question, of course, that the payment of rent for the use and occupancy of real estate ordinarily counts as an "actual, necessary" cost to which a landlord, as a creditor, is entitled. In order to survive, a financial entity almost always needs a physical space to occupy. When a debtor owns no suitable real estate of its own, its only choice is to become a tenant, and to assume the obligations of paying periodic rent to a landlord. In such circumstances, therefore, rent is clearly an "actual, necessary" cost of preserving the estate, since the debtor's survival depends on its ability to pay the landlord for the right to possess the space necessary to conduct its business. Because bankruptcy proceedings are considered to be equitable, however, the landlord's right to collect monetary relief is somewhat curtailed: a debtor is generally required to pay only a reasonable value for the use and occupancy of the landlord's property, which may or may not equal the amount agreed upon in the terms of the lease.

In re Sportsman's Warehouse, Inc., 436 B.R. 308, 315-16 (Bankr. D. Del. 2009) (quoting *Zagata Fabricators, Inc. v. Superior Air Prods.*, 893 F.2d 624, 627 (3d Cir. 1990)). *See also In re Goody's Family Clothing, Inc.*, 392 B.R. 604, 609 (Bankr. D. Del. 2008) (holding that Section 365 is not the sole basis to allow and pay landlords' administrative expense claims, and the court may also allow administrative claims under Section 503(b)(1)).

Under Section 503(b)(1)(A), a landlord is entitled to an administrative expense claim for "the actual, necessary costs and expenses of preserving the estate. . . ." 11 U.S.C. § 503(b)(1)(A). In determining whether an expense meets this standard, courts generally consider: (1) whether the expense arose from a transaction with the estate, and (2) whether it benefitted the estate in some demonstrable way. *Williams v. IMC Mortg. Co. (In re Williams*), 246 B.R. 591, 594 (B.A.P. 8th Cir. 1999). To satisfy this test, a landlord must show that it furnished consideration to the debtor post-petition and, as a result of this consideration, provided a tangible benefit to the bankruptcy estate. *Id.*

The amount of a landlord's administrative expense claim is measured by the amount of benefit received by the debtor, which is the reasonable rental value of the debtor's use of the property. *Wedemeier v. Fokkena*, 237 F.3d 938, 941 (8th Cir. 2001) ("As to the valuation of landlords' administrative claims for rent, the Bankruptcy Appellate Panel was correct in holding that the reasonable rental value of the property used provides the measure of landlords' administrative claim for rent."); *Williams*, 246 B.R. at 594 n.4 ("In rental situations, the measure [of an administrative expense claim] is the reasonable rental value of the property occupied."). This amount may—or it may not—equal the rent provided for in the lease.

While the reasonable rental value of the landlord's property is not necessarily the amount set forth in the lease, a rebuttable presumption exists that the lease rate represents the proper value. To determine the reasonable rental value, "the amount set forth in the contract or lease will constitute a rebuttable presumption that such amount is the correct measure of reasonable rental value." 4 *Collier on Bankruptcy* ¶ 503.06[6][c][ii] (16th ed. 2017). *See, e.g., In re Litho Specialties*, 154 B.R. 733, 740 (D. Minn. 1993); *In re Espinosa*, 542 B.R. 403, 412 (Bankr. S.D. Tex. 2015); *In re Raymond Cossette Trucking, Inc.*, 231 B.R. 80, 85 (Bankr. D.N.D. 1999) ("As for leased property, most courts take the position that the rent specified in the lease itself is the presumed reasonable value of the property to the debtor-in-possession"); *In re JAS Enters.*, 180 B.R. 210, 217 (Bankr. D. Neb. 1995); *In re Cybernetics, Inc.*, 111 B.R. 32, 40-41 (Bankr. N.D.N.Y. 1989) (holding that the amount of the lessor's administrative expense claim was based upon the value specified in the lease); *In re Western Monetary Consultants*, 100 B.R. 545, 547 (Bankr. D. Colo. 1989).

To overcome the presumption that the lease rate represents the reasonable rental value of the landlord's property, the debtor must introduce evidence of contrary rental value. *See Sportsman's Warehouse*, 436 B.R. at 315-16 (stating fair market value of rent "is presumably the lease rate unless there is evidence to the contrary") (quoting *Goody's Family Clothing, Inc.*, 392 B.R. at 614). *See also* Fed. R. Evid. 301 ("In a civil case, … the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption.").

4. <u>Possible Arbitrary Results: Accrued Post-Petition Charges and Annual Reconciliations</u>

As described by the Eighth Circuit in *Burival*, the "billing date" approach to Section 365(d)(3) is supported by the statute's plain language, which requires the debtor to timely perform all obligations "arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected…."

Although many courts apply the "billing date" approach because it is most consistent with the statutory language, courts also acknowledge that it can lead to arbitrary results. *See, e.g., In re Victory Mkts.*, 196 B.R. 6, 10 (Bankr. N.D.N.Y. 1996) (stating that "billing date" courts "acknowledge[e] the fact that awarding payments pursuant to the terms of the lease may produce arbitrary results depending on the date the petition was filed," but they "decline[] to alter what appears clear in the language of Code § 365(d)(3)."). This is especially true where post-petition charges accrue under a lease but they are not yet payable, or (as in *Burival*) where a lease requires the debtor to make a large post-petition payment based on charges that accrue throughout the year.

Where a lease requires the debtor to pay real estate taxes and insurance, for example, such charges are plainly part of the debtor's cost of renting the property, and the debtor should pay these charges in exchange for its post-petition use. However, if such charges do not become payable until after the debtor rejects the lease, under the "billing date" approach, they will likely not be covered by Section 365(d)(3), resulting in a possible windfall for the debtor.

Conversely, where a lease provides for annual or semi-annual payments, or where monthly charges are reconciled on an annual basis, the debtor could be liable to pay large amounts under Section 365(d)(3) if these charges become due post-petition, but before the lease is rejected. In such cases, the debtor would be required to pay significantly more than the actual rental value of the property in exchange for its post-petition use.

B. Personal Property Leases

1. Typical Lease Obligations Payable Under Personal Property Leases

Similar to triple-net leases of non-residential real property, lessees of personal property ordinarily agree to pay a "rent" obligation to the lessor for the right to possess the personal property, and they also agree to pay all insurance, applicable licensing and/or permit fees, and applicable personal property tax obligations with respect to the leased assets.

The insurance, license/permit, and property tax obligations are usually payable when due. However, in contrast to many non-residential real property leases where the "rent" obligation is often paid monthly, the structure of personal property leases creates a wide variety of payment terms. The rent obligation can be paid monthly, quarterly, semi-annually, annually, or on an irregular basis as established by lessor and lessee.

2. Lease Obligations Due in the First 59 Days – Section 503(b)(1)

During the first 59 days of a Chapter 11 bankruptcy case, a personal property lessor's entitlement to receive post-petition rent or payment of other lease obligations depends on whether the debtor uses and receives a benefit from the leased property. Under Section 503(b)(1)(A) of the Bankruptcy Code, a lessor is entitled to an administrative expense claim for "the actual, necessary costs and expenses of preserving the estate . . . .". 11 U.S.C. § 503(b)(1)(A). To gain administrative expense status, the lessor must show it furnished consideration to the debtor and, as a result of this consideration, the debtor received a "direct benefit" to the bankruptcy estate. *See, e.g., In re John's Meat Emporium Inc.*, 176 B.R. 700, 707 (Bankr. E.D.N.Y. 1995) (holding that a creditor was entitled to an administrative expense claim for the debtor's post-petition use of leased vans). Unlike Section 365(d)(5) (discussed below), the burden of proof under Section 503(b)(1) is on the lessor seeking an administrative expense claim. *In re Sylva Cop.*, 519 B.R. at 782 (citing *Williams*, 246 B.R. at 594).

"When a debtor in possession uses a creditor's equipment to generate funds for the operation of a business in bankruptcy, the creditor's expense of providing that equipment is an actual and necessary cost of preserving the estate under Section 503(b)." *In re John's Meat Emporium Inc.*, 176 B.R. at 707 (citing *In re Carpet Center Leasing Co.*, 991 F.2d 682, 687 (11th

Cir. 1993)). Therefore, where a debtor retains possession of a lessor's equipment and uses it to conduct its business, a presumption exists that the lessor is entitled to an administrative expense claim for all post-petition amounts due under the lease. *See Raymond Cossette Trucking, Inc.*, 231 B.R. at 85 ("As for leased property, most courts take the position that the rent specified in the lease itself is the presumed reasonable value of the property to the debtor-in-possession"); *Cybernetics, Inc.*, 111 B.R. at 40-41 (holding that the amount of the administrative expense claim was based upon the value specified in the lease).

In cases under Chapters 7, 12, and 13, a lessor's ability to have lease obligations deemed an administrative expense of the estate, regardless of whether they arise before or after 60 days from the petition date until the date the lease is assumed or rejected, is determined under Section 503(b)(1) of the Bankruptcy Code.

3. <u>Lease Obligations Due On or After the 60th Day of a Chapter 11 Case – Section 365(d)(5)</u>

Section 365(d)(5) (formerly section 365(d)(10)) provides, in relevant part:

> The trustee shall timely perform all of the obligations of the debtor … first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property … until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof.

11 U.S.C. § 365(d)(5). Under this section, a lessor of personal property in a Chapter 11 case is entitled to receive payment of all lease obligations that become due on or after the 60th day following the petition date, without the necessity of meeting the requirements of Section 503(b)(1)(A).

Under Section 365(d)(5), a lessor's entitlement to an administrative expense claim "is automatic" unless the debtor (or other objecting party) can show that the court should order otherwise based on the equities of the case. *Sylva Corp., Inc.*, 519 B.R. at 782. The overall purpose of this section is to "shift to the debtor the burden of bringing a motion while allowing the debtor sufficient breathing room after the bankruptcy petition to make an informed decision." *CIT Commc'ns Fin. Corp. v. Midway Airlines Corp. (In re Midway)*, 406 F.3d 229, 240-41 (4th Cir. 2005) (citing H.R. Rep. No. 103-835, at 50 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3359). *See also In re D. M. Kaye & Sons Transport, Inc.*, 259 B.R. 114, 119 (Bankr. D.S.C. 2001) ("Thus, while a creditor may be entitled to an administrative claim for rents due during the first 59 days of the case if the requirements of § 503(b)(1)(A) are satisfied, after the expiration of the 59-day period, the trustee is required to timely perform under the lease until assumption or rejection, whether or not the lease is beneficial to the bankruptcy estate."). Under Section 365(d)(5), therefore, once 60 days pass after the debtor files for bankruptcy, the lessor is entitled to receive all required payments due under its lease until the lease is assumed or rejected. *See In re Edison*

Brothers Stores, Inc., 207 B.R. 801, 807 (Bankr. D. Del. 1997) (stating the debtor is required to perform its obligations under a lease of point-of-sale cash registers under § 365(d)(10) [now § 365(d)(5)] arising after 60 days from the order for relief until the lease is either assumed or rejected).

4. The "Equities of the Case" Exception to Section 365(d)(5)

In contrast to the language of Section 365(d)(3), Section 365(d)(5) contains an equitable exception to the debtor's obligation to pay post-petition rent to a lessor of personal property. Indeed, while Section 365(d)(5) expressly requires a debtor to "timely perform" all obligations first arising on or after 60 days after the petition date, it also permits the court "after notice and a hearing and *based on the equities of the case*, [to] order[ ] otherwise…." *See* 11 U.S.C. § 365(d)(5) (emphasis added).

Under the plain language of this statute, whether a lessor is entitled to an administrative claim with priority over other creditors is based on the bankruptcy court's determination of the equities of the case. *See, e.g., Computer Sales Int'l v. Federal-Mogul Global Inc. (In re Federal-Mogul Global, Inc.)*, 331 B.R. 160, 167 (D. Del. 2005) ("Section 365(d)(5) allows a bankruptcy court the ability and discretion to disavow" the obligations under an unexpired lease of personal property "if it determines that the recovery of rent would be inequitable").

When determining the "equities of the case" under Section 365(d)(5), "the court must weigh the totality of the circumstances in light of the effect on the [debtor's] estate." *Energy Income Fund, L.P. v. Compression Solutions, Co., L.L.C. (In re Magnolia Gas Co., L.L.C.)*, 255 B.R. 900, 918 (W.D. Okla. 2000). By way of example, many courts have recognized it would be unfair to allow a lessor a priority claim over other creditors where: (1) the bankruptcy estate received no benefit from the landlord's property, and (2) the landlord did nothing to seek payment from the debtor on a timely basis, and instead let its administrative expense claim continue to accrue. As Judge Kressel recognized in his dissenting opinion in *Burival v. Creditor Comm. (In re Burival)*, 406 B.R. 548 (B.A.P. 8th Cir. 2009):

> The obligation by the debtor or the trustee to pay is a powerful weapon in a landlord's arsenal. For example, it can go to the bankruptcy court and ask it to order the debtor to pay; it can ask for relief from the automatic stay, alleging that failure to pay constitutes cause under § 362(d); it can move to dismiss the case under § 1112(b); it can argue for shortening the period in which the debtor is allowed to assume or reject the lease; and it can object to the debtor's request to extend the time for it to assume or reject. However, like most rights granted to creditors, they must be exercised to be effective. *What a landlord cannot do is allow time to run and then assert a large priority claim at the expense of other creditors, some of whom have congressionally granted priority claims.*

Burival v. Creditor Comm., 406 B.R. at 556-57 (Kressel, J., dissenting) (emphasis added). *See also In re DBSI, Inc.*, 407 B.R. 159, 164 (Bankr. D. Del. 2009) ("The appropriate remedy for a violation of Section 365(d)(3) is to cause the lease to be rejected in a timely fashioned manner."); *Omni Partners, L.P. v. Pudgie's Dev., Inc. (In re Pudgie's Dev., Inc.)*, 239 B.R. 688, 696 (Bankr. S.D.N.Y. 1999) ("What a landlord cannot do is sit idly by and not seek either payment or recovery of the premises by relying on the fact that his contractual rent will be accorded administrative priority."); *In re Mr. Gatti's*, 164 B.R. 929, 935-37, 943-46 (Bankr. W.D. Tex. 1994) (discussing cases and holding that a landlord with unpaid post-petition rent should not automatically receive an administrative priority claim over other creditors); *In re Tammey Jewels, Inc.*, 116 B.R. 292, 294 (Bankr. M.D. Fla. 1990) ("It would be truly an unfair proposition to permit the landlord to sit idly by and not seek either payment or recovery of the premises by relying on the fact that his contractual rent will be accorded administrative priority [where the property was not] occupied and presented no benefit to the estate."). Although these cases discuss real property leases under Section 365(d)(3) (and not personal property leases under Section 365(d)(5)), their discussion of fairness considerations between landlords, tenants and other creditors may be pertinent to a court's consideration of the equities of a case under Section 365(d)(5).

5. True Lease v. Disguised Secured Transaction

A key issue for lessors of personal property to be entitled to the benefits of Section 365, as opposed to being governed by other Bankruptcy Code sections applicable to secured creditors, is whether the instrument labeled as a "lease" is a true lease or a disguised security agreement. Indeed, just because an agreement is called a lease, doesn't mean it is one. To determine whether an agreement is a true lease or a disguised security instrument, bankruptcy courts must look to state law.

The Uniform Commercial Code as enacted in Minnesota provides in relevant part:

- A lease is "a transfer of the right to possession and use of goods for a term in return for consideration, but a sale ... or retention or creation of a security interest is not a lease." Minn. Stat. § 336.2A-103(1)(j)

- A security interest "means an interest in personal property or fixtures which secures payment or performance of an obligation." Minn. Stat. § 336.1-201(35).

According to Minn. Stat. § 336.1-203(b):

> Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, ***and***:
>
> (i) the original term of the lease is equal to or greater than the remaining economic life of the goods;

> (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
>
> (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or
>
> (iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Minn. Stat. § 336.1-203(b) (emphasis added). This analysis is commonly referred to as the "bright-line" test. Under this test, if the lessee does not have the right to terminate the agreement before the end of its term, *and* any of the four factors set out in section Minn. Stat. § 336.1-203(b) are met, then the agreement would be considered to create a security interest as a matter of law.

However, if it is determined that "the transaction is not a disguised security agreement *per se*, courts must then look at the specific facts of the case to determine whether the economics of the transaction suggest such a result." *In re Taylor*, 209 B.R. 482, 484 (Bankr. S.D. Ill. 1997). This is commonly referred to as the "economic realities" test.

The most common elements of the bright-line test examined by bankruptcy courts are whether the renewal or purchase options made available to the lessee are nominal. To determine whether a purchase option is nominal, courts examine whether it is less than the lessee's reasonably predictable cost of performing under the agreement if the option is not exercised. Additional consideration is not nominal if:

> (1) When the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or
>
> (2) When the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed.

Minn. Stat. § 336.1-203(d).

KEY ISSUE: The "remaining economic life of the goods" and "reasonably predictable" fair market rent, fair market value, and cost of performing under the agreement are determined by examining the facts and circumstances at the time the transaction is entered into. Minn. Stat. § 336.1-203(e).

Some of the factors examined by courts in determining whether a lease is a true lease or a disguised security instrument include:

a. Lessee's Right to Terminate

In re Sanford, 2005 WL 629022 (Bankr. M.D. La. 2005):

- Held that agreement was a true lease because the lessee could terminate it at will and it was a month-to-month agreement with no defined term.

b. $1 Out Leases

In re ES2 Sports 8 Leisure, LLC, 519 B.R. 476 (M.D.N.C. 2014):

- Agreement with a $1 purchase option at end of term is not a true lease but rather a disguised security agreement.

c. Percentages of Cost/Value

CIT Technology Financing Services, Inc. v. Tricycle Enterprises, Inc., 787 N.Y.S.2d 133 (App. Div. 2004):

- Purchase option price of 10 percent of "total cash price" (interpreted by the court to mean the total of all payments to be made over the five-year term of the lease), which equated to 30 percent of the equipment's remaining residual value at the end of the lease term, was not nominal as a matter of law and the agreement was a true lease.

In re Sankey, 307 B.R. 674 D. Alaska (2004):

- Held true lease because purchase option at end of lease for a sum that was precisely 10 percent of the value of the equipment at inception was within reasonably predictable fair market value.
- Made clear that determination is based on facts and circumstances existing at the inception of the agreement, not those that exist at some later point.

In re Wells, 2015 WL 3862969 (N.D. Ala. 2015):

- Examines the value of the equipment at the end of the term to determine the lease is a true lease.
- Lessor and lessee disputed whether purchase option price should be reviewed as to a percentage of the vehicle's original agreed upon value of 20 percent or as to the percentage of the option price in consideration of value of the vehicle at the end of the term (38.8 percent).
- The court holds that it doesn't matter because the purchase option price is not nominal – relies on a 1987 Sixth Circuit decision (*Celeryvale Transport, Inc. v. N.W. Kellogg Comp.*, 822 F.2d 16, 19 (6th Cir. 1987)) which found that a 10 percent purchase option was not nominal.

d. Transaction Economics and Market

In re Pillowtex, Inc., 349 F.3d 711 (3d Cir. 2003):

- Lease was a disguised security agreement where, although the useful life of the equipment far exceeded the lease term, the aggregate rental payments owed had a present value exceeding the cost of the equipment and there was little (if any) market value for the equipment at the end of the term.
- The court reasoned that it would have made no economic sense for the lessee to spend large amounts of money to reclaim the equipment, particularly in the face of poor resale prospects.

In re Chance Industries, Inc., 2002 WL 32653678 (Bankr. D. Kan., March 29, 2002):

- Determined that four leases were disguised security agreements where debtor's option at the end of the leases was to either exercise purchase options totaling $15,700 or continue leasing the equipment for 12 additional months at a total cost of $126,000.
- The court stated that the debtor was clearly obligated to exercise the purchase options under the circumstances and "would be a fool not to purchase."

In re Ajax Integrated, LLC, 554 B.R. 568 (N.D.N.Y. 2016):

- Determined on summary judgment that lease was a disguised security agreement.
- Key was that court found that purchase option was nominal as compared to the lessee's reasonably predictable cost of performance of return provisions contained in agreement.
- Anticipated repair and return transportation costs necessary to comply with agreement were several thousand dollars more than the $16,900 end-of-term purchase option.

In re Ecco Drilling Co., Ltd., 390 B.R. 221 (Bankr. E.D. Tex. 2008):

- Equipment at issue were drilling rigs and purchase option price was fixed to be 15 percent of the greater of the value of the equipment or 60 percent of the going concern value of the lessee.
- In determining that leases were disguised security agreements, the court focuses on the economic realities.
- Factors relied upon by the court included that the equipment constituted the primary assets the debtor needed to conduct its business, the debtor's considerable investment to procure and adapt the rigs to meet its specific business needs, that neither the debtor nor the lessor anticipated that the equipment would ever be returned, and that no projection or contingency was ever made regarding the return of the equipment.

- Of note, the court reasoned that the "transaction was not structured in anticipation that [the debtor] would simply walk away from these rigs four years into a 30-year useful life."

In re QDS Components, Inc., 292 B.R. 313 (Bankr. S.D. Ohio 2002):

- In determining leases were true leases, the court rejects the lessee's claim that lessors relinquished their reversionary interest in the equipment in light of the economics of the transactions.
- Lessee argued that in light of the cost to return the equipment and the anticipated one to two years of useful economic life at the end of the term, the only sensible decision was to exercise the purchase option and retain the equipment.
- The court held that lessee's failure to introduce evidence showing the projections of residual value, return shipping costs, and estimated remaining economic life at lease end made by the parties at lease inception was fatal to lessee's argument and the court assumed no such projections existed.

e. Residual Interest

In re Edison Bros. Stores, Inc., 207 B.R. 801 (Bankr. D. Del. 2004):

- Court examines multiple factors in determining leases are true leases, rejecting most of them as determinative.
- Focuses on evidence presented as to the useful life of the equipment (point of sale equipment), which the court found was two to four years more than the lease term, therefore finding that lessor had a meaningful residual interest.

In re Purdy, 763 F.3d 513 (6th Cir. 2014):

- The "equipment" was a herd of 435 cows.
- Bankruptcy court determined the lease was a disguised security agreement because in failed to pass the bright-line test on account of evidence that approximately 30 percent of the cows were culled each year, meaning that the entire heard would have turned over in 40 months. The lease term was 50 months.
- The Sixth Circuit reversed, holding the bankruptcy court erred in analyzing the economic life of the individual cows originally leased, rather than examining the life of the herd as the plain language of the lease required the lessee to return the name number of cattle to lessor, not the same cattle.
- Further, the Sixth Circuit held that application of the economic realities test further supported a true lease conclusion because the lease had no purchase option whatsoever. Due to the price obtained at auction, the lessor clearly realized a meaningful reversionary interest.

In re Lasting Impressions Landscape Contractors, Inc., 579 B.R. 43 (Bankr. D. Md. 2017):

- Master lease and seven schedules for motor vehicles at issue.
- Not clear whether TRAC leases, but master lease provided for purchase option or return of vehicles at end of term. The master lease further provided that if returned, vehicles would be sold. If net sale proceeds were less than the assumed residual, lessee was responsible for deficiency. If net sale proceeds exceeded the assumed residual, excess to lessee.
- Relying on that language, court determines that lessor did not reserve a meaningful revisionary interest and has no up-side or down-side risk.
- Court also reasoned that vehicles had an expected useful life of 5-10 years more than lease term and that effective purchase option was the equivalent of 5.5 months of payments; therefore, the only sensible course would be to exercise the option at the end of the term.
- Accordingly, lease was determined to be a disguised security instrument.

f. TRAC (terminal rental adjustment clauses)

In re HB Logistics, LLC, 460 B.R. 291 (Bankr. N.D. Ala. 2011):

- Held that TRAC leases were true leases despite debtor's argument that application of the bright-line and economic realities tests effectively repealed or overruled TRAC statute.
- In reviewing the lease terms, the anticipated values of the vehicles, and other information presented, the court determined that the original term of the leases was not equal to or greater than the remaining economic life of the trucks, that the purchase option price was a reasonable estimate of the fair market value of the equipment, and that the lessors retained a significant reversionary interest.
- The court specifically rejected the lessee's argument that the TRAC language effectively transferred all risk and reward of ownership to it and that the lessors had no meaningful reversionary interest.

In re Lighting Bolt Leasing, LLC, Case No. m3:15-bk-05173-JAF (Bankr. M.D. Fla. 2016):

- Held that TRAC lease was a disguised security agreement because the lessor retained no risk associated with the sale or other disposition of the equipment and therefore effectively divested the lessor of any real residual interest in the equipment.
- Is an outlier and is in direct conflict with TRAC statutory language.

II. ASSUMPTION AND ASSIGNMENT OF LEASES

A. The Debtor's Assumption of Unexpired Leases

Under Section 365(a) of the Bankruptcy Code, "[e]xcept as provided … in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). By its terms, Section 365(a) authorizes a debtor to assume only "unexpired lease[s]" of the debtor, not a lease that terminated pre-petition.

Section 365(b)(1) provides that if a default has occurred under the lease, the trustee may *not* assume the lease unless, at the time of assumption, the trustee—

> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;
>
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1).

1. <u>Debtor's Obligation to Cure Defaults and Compensate the Lessor</u>

Under Section 365(b)(1)(A) and (B), to assume an unexpired lease, the debtor must cure all defaults under the lease as of the date of assumption and compensate the lessor for all losses incurred as a result of the debtor's default. *See* 11 U.S.C. § 365(b)(1)(A) and (B). These amounts will likely include: (1) all unpaid amounts due under the lease as of the petition date, (2) all unpaid amounts due under the lease between the petition date and the date of assumption, and (3) all unpaid amounts that have accrued, or may accrue, under the lease that are subject to periodic adjustment or reconciliation.

In addition to these amounts, leases typically require the lessee to pay interest on all past-due obligations under the lease. They also frequently entitle the lessor to recover all damages reasonably sustained by it on account of the lessee's breach of the lease, including reasonable attorney's fees and costs. These amounts, too, would fall within a debtor's obligation to cure all defaults and compensate the lessor under Section 365(b)(1)(A) and (B).

2. <u>Adequate Assurance of Future Performance</u>

Under Section 365(b)(1)(C), a debtor cannot assume a lease unless, at the time of assumption, the debtor provides adequate assurance of its ability to perform under the lease in the future. The debtor bears the ultimate burden of persuasion on this issue. *See, e.g., Richmond Leasing Co. v. Capital Bank, N.A.*,762 F.2d 1303, 1309 (5th Cir. 1985); *In re F. W. Restaurant Assoc., Inc.*, 190 B.R. 143 (Bankr. D. Conn. 1995); *In re Rachels Industries, Inc.*, 109 B.R. 797, 802 (Bankr. W.D. Tenn. 1990).

In many non-residential real estate leases, lessees agree to indemnify the lessor and hold the lessor harmless from certain claims or losses, including any claims for personal injuries which may occur at the property, claims for damage to or destruction of the property, and environmental claims relating to the property. In such cases, to assume the lease, the debtor or any proposed assignee would be required to show, or to obtain adequate insurance in order to guaranty, that these indemnity responsibilities will be met.

B. Assignment of Leases to Third Parties

1. <u>The Debtor Must Assume the Lease and Provide Adequate Assurance of the Assignee's Ability to Perform</u>

Under Section 365(f)(1) of the Bankruptcy Code, a debtor may assign an unexpired lease of real or personal property "under paragraph (2) of this subsection." 11 U.S.C. § 365(f)(1). Section 365(f)(2), in turn, provides a debtor may assign an unexpired lease to a third party if:

> (A) the trustee assumes such contract or lease in accordance with the provisions of [section 365]; and
>
> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

Id. § 365(f)(2).

Adequate assurance of future performance will usually be demonstrated by financial information about the assignee's ability to make payments under the lease. In addition, to ensure an assignee will be able to perform under the lease, Section 365(l) permits a lessor to "require a deposit or other security for the performance of the debtor's obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant." *Id.* § 365(l). This additional security could take the form of a security deposit, a bond or insurance policy, or a third-party guaranty.

Once a lease has been assumed and assigned, Section 365(k) provides that assumption and assignment of the lease "relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment." *Id.* § 365(k).

2. <u>Anti-Assignment Clauses</u>

Section 365(f)(3) of the Code provides:

> Notwithstanding a provision in an … unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such … lease or a right or obligation under such … lease on account of an assignment of such … lease, *such … lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such … lease by the trustee.*

Id. § 365(f)(3) (emphasis added). Under Section 365(f)(3), anti-assignment provisions (which appear in many nonresidential real property and personal property leases) generally are unenforceable in bankruptcy. *See In re Lazy Days RV Ctr., Inc.*, 724 F.3d 418, 424 (3d Cir. 2013) ("The principle established by § 365(f)(3) is that anti-assignment clauses are unenforceable in bankruptcy.").

One exception to this is Section 365(c)(1), which prohibits a debtor from assigning a lease to a third party if:

> (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment. . . .

Id. § 365(c)(1). This exception to the debtor's ability to assume and assign a contract or lease generally is limited to personal services agreements, intellectual property licensing agreements, and partnership management agreements, where the identity of the parties is central to the agreement itself. As such, this exception is unlikely to arise in a leasing context.

C. Shopping Center Leases

If a debtor is a tenant in a shopping center, unique problems arise when the debtor seeks to assume and assign its lease to third parties. Congress enacted Section 365(b)(3) of the Bankruptcy Code to address these issues.

Because the Bankruptcy Code does not define the term "shopping center," the definition of what is a "shopping center" is left to case-by-case interpretation. *In re Joshua Slocum, Ltd.*, 922 F.2d 1081, 1086 (3d Cir. 1990); *In re Goldblatt Brothers, Inc.*, 766 F.2d 1136, 1140 (7th Cir. 1985). The legislative history of the Bankruptcy Reform Act of 1978 states:

> A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus, a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 348 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6305.

In Section 365(b)(3), "Congress recognized that unlike the usual situation where a lease assignment affects only the lessor, an assignment of a shopping center lease to an outside party can have a significant detrimental impact on others, in particular, the center's other tenants." *Joshua Slocum, Ltd.*, 922 F.2d at 1086. To protect landlords and the other tenants, Section 365(b)(3) prohibits a debtor from assuming or assigning a shopping center lease unless the debtor provides adequate assurance of future performance beyond what is normally required under Sections 365(b)(1) and (f)(2)(B). Specifically, Section 365(b)(3) provides:

> For purposes of [§§ 365(b)(1) and (f)(2)(B)], adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—
>
> (A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
>
> (B) that any percentage rent due under such lease will not decline substantially;

> (C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
>
> (D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

11 U.S.C. § 365(b)(3). These additional requirements are meant to remedy three serious problems suffered by shopping centers and their tenants when a tenant files for bankruptcy. Specifically:

> Congress wished to alleviate the hardship caused landlord and tenant resulting from vacancy or partial operation of the debtor's space in the shopping center. Section 365 also insures that the landlord will continue to receive payments due under the lease. Finally, the statute guarantees to the landlord and remaining tenants that the tenant mix will not be substantially disrupted.

Joshua Slocum, Ltd., 922 F.2d at 1088 (quoting 130 Cong. Rec. S8891 (statement by the Hon. Orrin G. Hatch), reprinted in 1984 U.S.C.C.A.N. 590, 598). Accordingly, unless the debtor or its assignee provide the additional adequate assurance required by Section 365(b)(3), the debtor will not be permitted to assume or assign a shopping center lease.

D. Time for Assumption or Rejection

1. Non-Residential Real Property Leases

For leases of non-residential real property, the Bankruptcy Code establishes a 120-day deadline for debtors to decide whether to assume or reject the lease. Section 365(d)(4) provides:

> (A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—
>
> (i) the date that is 120 days after the date of the order for relief; or
>
> (ii) the date of the entry of an order confirming a plan.
>
> (B) (i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-

> day period, for 90 days on the motion of the trustee or lessor for cause.
>
> (ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

11 U.S.C. § 365(d)(4).

2. <u>Personal Property Leases</u>

In contrast to Section 365(d)(4), the Bankruptcy Code does not establish an early deadline for assuming or rejecting leases of personal property in matters other than those under Chapter 7. For those leases, Section 365(d)(2) provides:

> In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

11 U.S.C. § 365(d)(2).

Under Section 365(d)(1) of the Bankruptcy Code, in Chapter 7 cases all unexpired leases of personal property (and leases of residential real property) are deemed rejected if they are not assumed or rejected within 60 days from the order for relief, or within such additional time as the court, upon a showing of cause, determines.

Although Section 365(d)(2) does not set an early deadline for debtors to assume or reject personal property leases, personal property lessors are not without a remedy where a debtor fails to make payment to the lessor. As discussed more fully below, under Section 365(d)(2), "the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease." *Id.*

III. LEASE REJECTION AND DAMAGES

A. Surrender of Property to the Lessor

If a debtor rejects a lease of non-residential real property, the Bankruptcy Code does not expressly state whether the court can order the debtor to surrender the property to the landlord, or whether the landlord is required to exercise its remedies under state law. In Section 365(d)(4), however, the Code states that, if a debtor does not assume or reject the lease by the applicable deadline, the lease "shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor…." 11 U.S.C. § 365(d)(4). While this provision does not directly apply to situations where a debtor actively rejects a lease, a lessor has a strong argument that its rights upon rejection are the same, and the court may order the debtor to surrender the property to the lessor. *See* 3 *Collier on Bankruptcy* ¶ 365.10[4] (16th ed. 2018) ("The better approach in a case involving a lease of nonresidential real property is to analogize to § 365(d)(4) and to require the debtor to surrender leased premises after rejection of the lease, without the necessity to suffer further delay by engaging in eviction proceedings under nonbankruptcy law.").

Unfortunately for lessors of personal property, there is no provision of the Bankruptcy Code requiring the debtor to surrender possession of the leased property to the lessor upon rejection. However, Section 365(p)(1) offers some protection to equipment lessors by terminating the automatic stay immediately upon rejection of the lessor's lease. *See* 11 U.S.C. § 365(d)(4) ("if a lease of personal property is rejected or not timely assumed by the trustee under subsection (d), the leased property is no longer property of the estate and the stay under section 362(a) is automatically terminated."). Therefore, while the bankruptcy court is unlikely to require the debtor to deliver the property to the lessor, the lessor is free to exercise its remedies to repossess the property immediately upon rejection.

B. Lessor's Pre-Petition Claim for Rejection Damages

Section 365(g) provides "the rejection of an … unexpired lease of the debtor constitutes a breach of such contract or lease—(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition…." 11 U.S.C. § 365(g). Under this section, all damages a lessor incurs from the debtor's breach of the lease (including claims for future unpaid rent) constitute a pre-petition claim against the debtor, for which the lessor is entitled to file a proof of claim.

Under Section 502(b)(6) of the Bankruptcy Code, if a party objects to a lessor's claim under a real property lease, the court shall determine the proper amount of the claim, and it shall allow the claim, except to the extent that—

> (6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—
>
> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of—
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

> (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

11 U.S.C. § 502(b)(6). This cap on a landlord's damages is "designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate." *Lariat Co's. v. Wigley (In re Wigley)*, 533 B.R. 267, 270 (B.A.P. 8th Cir. 2015) (quoting S. Rep. No. 95-989, at 63 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5849).

When asserting a claim for damages against a bankruptcy estate, a landlord has a duty to mitigate its damages. A landlord's duty to mitigate does not change how the landlord's Section 502(b)(6) cap is calculated. *Fifth Ave. Jewelers v. Great E. Mall (In re Fifth Ave. Jewelers)*, 203 B.R. 372, 381(Bankr. W.D. Pa. 1996) ("The overwhelming majority of courts have held that the § 502(b)(6) statutory cap is not reduced by any amount a landlord has received by reletting the leased premises and mitigating its damages."). Nevertheless, a landlord's duty to mitigate does alter the landlord's underlying claim for damages under applicable non-bankruptcy law, which may reduce its overall recovery under Section 502(b)(1). In essence, therefore, the measure of damages under Section 502(b)(6) is the lesser of: (i) the statutory formula calculated under Section 502(b)(6), or (ii) the measure of damages that takes into account other defenses to the landlord's claim. 4 *Collier on Bankruptcy* ¶ 502.03[7][i] (16^{th} ed.).

IV. LESSORS' REMEDIES WHEN A DEBTOR FAILS TO COMPLY WITH SECTION 365(d)

When a debtor fails to comply with its Section 365(d) obligations, lessors under non-residential real property or personal property leases may file a motion under Section 362(d) for relief from the automatic stay or a motion under Section 503(b)(1) for allowance and immediate payment of their administrative expenses. Additionally, personal property lessors may file a motion under Section 365(d)(2) asking the court to shorten the debtor's time to assume or reject a lease.

A. Motions for Relief from the Automatic Stay

Section 362(d) provides, in part:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay . . .
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
>
> (2) with respect to a stay of an act against property . . . if-
>
> (A) the debtor does not have an equity in such property; and

> (B) such property is not necessary to an effective organization. . . .

11 U.S.C. § 362(d). Accordingly, lessors may seek relief from the automatic stay either for "cause" under Section 362(d)(1) or, under Section 362(d)(2), because the debtor lacks equity in the leased property and the leased property is not necessary to an effective reorganization.

1. Section 362(d)(1): Relief for "Cause"

Because "cause" under Section 362(d)(1) is not defined in the Bankruptcy Code, it is determined on a case-by-case basis. *See Mac Donald v. Mac Donald (In re Mac Donald)*, 755 F.2d 715, 716 (9th Cir. 1985) ("Because there is no clear definition of what constitutes 'cause', discretionary relief from the stay must be determined on a case by case basis."). The standard for "cause" under Section 362(d)(1) is broad, "and may extend beyond the one enumerated ground of lack of 'adequate protection' . . . ." *In re Lilyerd*, 49 B.R. 109, 116 (Bankr. D. Minn. 1985).

Accordingly, a debtor's failure to comply with its Section 365(d)(3) or (d)(5) obligations may constitute "cause" under Section 362(d)(1). *See In re Pudgie's Dev.*, 223 B.R. 421, 427 (Bankr. S.D.N.Y. 1998) (noting that a lessor "may enforce his right to timely performance under Section 365(d)(3) by moving to lift the stay for cause under Section 362(d)(1). . . ."); *In re Sturgis Iron & Metal Co., Inc.*, 420 B.R. 716, 744 (Bankr. W.D. Mich. 2009) (noting that "Section 365(d)(5) clearly entitles the equipment lessor to have the stay immediately lifted . . . in the event the trustee does not perform as that subsection requires").

A failure to insure leased property or to pay additional rent as required by a lease also may constitute "cause" for lifting the automatic stay. *See In re Harwood Hideout, Inc.*, No. 04-31494, 2005 WL 894828, *3 (Bankr. D.N.D. Mar. 4, 2005) ("Nonpayment of taxes and failure to insure property may constitute cause under section 362(d)(1).").

2. Section 362(d)(2): Relief for Lack of Equity *and* Unnecessary to an Effective Reorganization

A lessor also may seek relief from the automatic stay because a debtor lacks equity in the leased property and the leased property is not necessary to the debtor's effective reorganization. Under Section 362(g), the lessor has the burden of proof on the issue of the debtor's equity in the leased property and the debtor has the burden of proof on all other issues.

Provided the lease at issue is a true lease, debtors ordinarily lack equity in leased property. *See In re Our Secret, Ltd.*, 282 B.R. 697, 702 (Bankr. D. N.M. 2002) ("If the agreements are leases, then the debtor's only interest will be in its leasehold estate; it will have no equity in the property . . . .").

In *United Savings Association of Texas v.Timbers of Inwood Forest*, the United States Supreme Court articulated the standard for determining whether property is necessary to an effective reorganization:

> What this requires is not merely a showing that if there is conceivably to be an effective reorganization, this property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect.* This means . . . that there must be 'a reasonable possibility of a successful reorganization within a reasonable time.'

484 U.S. 365, 375–77, 108 S.Ct. 626, 632–33 (1988) (citation omitted; emphasis in original).

B. Motions to Shorten Time to Assume or Reject Personal Property Leases

Section 365(d)(2) provides:

> In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan *but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.*

11 U.S.C. § 365(d)(2) (emphasis added).

Under this section, a personal property lessor may file a motion asking the court to shorten a debtor's time period to make its decision to assume or reject a lease. The lessor has the burden of demonstrating cause to shorten the time period. *See In re Hawker Beechcraft, Inc.*, 483 B.R. 424 (Bankr. S.D.N.Y. 2012).

Courts generally agree that debtors should be given a reasonable time to make their assumption and rejection decisions, consistent with the "broad rehabilitative purpose of chapter 11." *In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002). But what constitutes a reasonable time depends on the facts of each case. Some courts have established tests or identified factors to guide their determination. *See Theatre Holding Corp. v. Mauro*, 681 F.2d 102, 105 (2d Cir. 1982) (examining various factors and concluding that the debtor's assumption and rejection period could be shortened where the debtor had failed to file a plan within a year of its petition date); *In re Adelphia Commc'ns Corp.*, 291 B.R. 283, 293 (Bankr. S.D.N.Y. 2003) (developing a twelve-part test and examining, among other things, the importance of the contract to the debtor's business and reorganization efforts).

(When) Can Student Loans Be Discharged in Bankruptcy Without a Showing of Undue Hardship?

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New York

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE ________________________

In re JOHN DOE Debtor. JOHN DOE Plaintiff, v. NAME OF DEFENDANT Defendants.	Chap. 7 No. XX-XXXXX(XXX) Adv. Pro. No. XX-XXXXX

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

Plaintiff JOHN DOE ("DOE" or "Plaintiff") files this Motion for Partial Summary Judgment pursuant to Federal Rule of Civil Procedure 56 and Federal Rule of Bankruptcy Procedure 7056 on his claim for declaratory relief against Defendant __________ as follows:

I. STATEMENT OF FACTS

A. Background Of Section 523(a)(8) Of The United States Code.

ORAL ARGUMENT REQUESTED

Section 523(a)(8) of the Bankruptcy Code was originally enacted in 1978 to prevent discharge of certain student loans in bankruptcy proceedings.[1] In sum and substance, the original intent behind this discharge exemption was to provide some protection to government and non-profit institutions that were involved in student lending. Since 1978, it has undergone numerous revisions, three of which are crucial to understanding its current scope. The first iteration of the statute protected only government or non-profit student loans from discharge. Specifically, Section 523(a)(8) provided:

> (a) a discharge . . . does not discharge an individual debtor from any debt--
>
> (8) for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or part by a governmental unit or a nonprofit institution of higher education.[2]

The statute was amended in 1990 to address other forms of governmental education benefits. For instance, the federal government furthers higher education through service scholarships and grants, such as the Montgomery GI Bill and the National Health Service Corps Scholarship.[3] Prior to the 1990 amendments, students who

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[1] *See U.S. Dep't of Health & Human Servs. v. Avila (In re* Avila*)* 53 B.R. 933, 935 (Bankr. W.D.N.Y. 1985) ("The legislative history of subsection 523(a)(8) indicates that Congress sought to quell the situation where an individual graduated from college owing one or more educational loans and then discharged them through a bankruptcy proceeding without making a good faith effort to repay those loan.").

[2] *See* 11 U.S.C. 523(a)(8) (Supp. 1979).

[3] *See Mays v. Shinseki*, 25 Vet. App. 256, 261 (2012) (describing statutory scheme for military educational benefits).

took federal money in the form of these conditional educational scholarships and defaulted on a condition of the obligation (*e.g.,* failing to achieve passing grades) could obtain a discharge under a literal reading of the statute, which restricted discharge of student loans, not defaulted contractual obligations.[4] For this reason, Section 523(a)(8) was amended in 1990 to except from discharge an "obligation to repay funds received as an educational benefit, scholarship, or stipend."[5] After the 1990 amendment, the statute stated:

> (a) a discharge . . . does not discharge an individual debtor from any debt--
>
> (8) for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend.[6]

This language protected the government from a discharge regardless of whether its financial assistance took the form of student loans or conditional scholarships, benefits or stipends.

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[4] *See U.S. Dep't of Health & Human Servs. v. Smith* (*In re Smith*), Adv. Pro. No. 84-05113, 1985 WL 660512, at *1 (Bankr. D.N.D. June 26, 1985) *subsequently rev'd sub nom. U.S. Dep't of Health & Human Servs. v. Smith*, 807 F.2d 122 (8th Cir. 1986).

[5] *See* Federal Debt Collection Procedures of 1990: Hearing on P.L. 101-647 Before the H. Subcomm. on Econ. and Commercial Law, H. Judiciary Committee 101st Cong. 74-75 (June 14, 1990) (Mr. Brooks' Questions for the Record from Mr. Wortham).

[6] *See* 11 U.S.C. 523(a)(8)(1990); *Santa Fe Medical Services, Inc. v. Segal* (*In re Segal*), 57 F.3d 342, 347 (3d Cir. 1995) ("Subsection 523(a)(8) was yet again expanded by the Crime Control Act of 1990 . . . Most relevant to this case, however, was the addition of language which prohibited the discharge of 'an obligation to repay funds received as an educational benefit, scholarship, or stipend.'").

In 2005, the statute was amended again to extend protection to commercial lenders only to the extent their loan products mirrored and supplemented federal lending. Specifically, Congress awarded bankruptcy protection to private education loans that were made *solely* for qualified higher education expenses. Qualified higher education expenses are defined in federal law as debts incurred *solely* to cover the "Cost of Attendance" at a Title IV accredited institution.[7] The "Cost of Attendance" is determined and published by the school, and includes tuition, room, board, and books. In order to determine whether an education loan falls within the "Cost of Attendance" lenders must obtain school certification regarding the school's published costs, and the debtor's outstanding loan balance for that academic term. Where a debtor has already borrowed all the money he or she needs for the semester, the school's financial aid office rejects the student's application for additional loans. After 2005, the language of section 523(a)(8) stated:

> (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for—
>
> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

[7] Where part of a debt is used to cover qualified education expenses and part is not, the debt is a mixed-use loan, and therefore, not a qualified education loan. *See* IRS, 26 C.F.R. 1, REG-116826-97 ("Student I signs a promissory note for a loan which is secured by I's personal residence. Part of the loan proceeds will be used to pay for certain improvements to I's residence and part of the loan proceeds will be used to pay qualified higher education expenses of I's spouse. Because the loan is not incurred by I solely to pay qualified higher education expenses, the loan is not a qualified education loan.").

> (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
>
> (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual.[8]

As it stands today, Section 523(a)(8) of the Bankruptcy Code excepts from discharge three types of educational debts: (1) governmental or non-profit student loans; (2) conditional educational grants (*e.g.*, benefits, scholarships, and stipends); and (3) private student loans made for qualified higher education expenses.

B. Plaintiff's Factual And Procedural History

1. Plaintiff borrows more than $______ in DTC loans.

Between 20__ and 20___, Defendant lent Plaintiff more than $______ in non-certified, non-qualified, loans (the "Loans" or "Plaintiff's Non-Qualified Education Loans"). Prior to originating the Loans, Defendants did not conduct the necessary due diligence to ensure Plaintiff was an eligible student, or that the loans were being used solely for "qualified higher education expenses." Accordingly, Defendants could not determine whether the loans were qualified education loans, or else merely education loans made to a student.

2. Plaintiff files for relief under Title 11 and receives a discharge that extinguishes all pre-petition debt not encompassed by section 523(a). ________________________________

[8] *See* 11 U.S.C § 523(a)(8) (2015).

Plaintiff filed for relief under chapter __ of the Bankruptcy Code in _______ in the United States Bankruptcy Court for the ___________. On Schedule F, Plaintiff indicated that **he/she** was indebted to Defendants for $______ in educational loans. On ___, this Court entered an order discharging all of Plaintiff's properly scheduled pre-petition debt that is not excepted under section 523(a)(8).

II. LEGAL STANDARD

Summary judgment is only appropriate where the pleadings, discovery and disclosure materials on file, and affidavits demonstrate that there is no genuine issue as to any material fact and that movant is entitled to judgment as a matter of law.[9] The moving party bears the burden of showing that it is entitled to summary judgment.[10] When considering a motion for summary judgment, the court must view the evidence and draw all justifiable inferences in the light most favorable to the non-moving party.[11] Courts must limit the Bankruptcy Code's discharge exceptions to those "plainly expressed."[12] Accordingly, courts must interpret exceptions to discharge narrowly.[13]

[9] FED. R. BANKR. P. 7056; FED. R. CIV. P. 56(C); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986).

[10] *Nouveau Elevator Indus. v. Cont'l Cas. Ins. Co.*, 2006 U.S. Dist. LEXIS 41495, at * 8 (E.D.N.Y. June 21, 2006).

[11] *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986).

[12] *Bullock v. Bank Champaign, N.A.*, 133 S.Ct. 1754, 1760, 185 L.Ed.2d 922 (2013).

[13] *Kawaauhau v. Geiger*, 523 U.S. 57, 62, 118 S.Ct. 974, 140 L.Ed.2d 90 (1998).

III. ARGUMENT AND AUTHORITIES

A. Summary Of Argument

Plaintiff's loans were discharged upon entry of this Court's order because they are not educational debts excepted from discharge under section 523(a)(8). 11 U.S.C. § 523(a)(8) contains three distinct provisions restricting the discharge of certain kinds of student debt. First, section 523(a)(8)(A)(i) excepts from discharge an educational loan made under a government or nonprofit loan program. Second, section 523(a)(8)(A)(ii) excepts from discharge an obligation to repay funds received as an educational benefit, scholarship, or stipend. Third, section 523(a)(8)(B) excepts from discharge any other educational loan that is a qualified education loan as that term is defined in IRC 221(d). Accordingly, in order for an educational debt to be non-dischargeable, it must either be a student loan under sections 523(a)(8)(A)(i) or 523(a)(8)(B), or else a conditional educational grant under section 523(a)(8)(A)(ii). An educational debt that is not encompassed by section 523(a)(8) is treated as any other dischargeable consumer debt and is automatically discharged upon entry of discharge order. Where a creditor believes that a debt is a non-dischargeable student loan, the legal burden is on that creditor to demonstrate by a preponderance of the evidence that the debt in question is encompassed by section 523(a)(8).[14] Plaintiff's loans were not excepted from discharge under any three provisions of section 523(a)(8), and accordingly, were discharged upon entry of this Court's discharge order.

B. Plaintiff's Loans Are Not "made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution" Under Section 523(a)(8)(A)(i).

Plaintiff's Non-Qualified Education Loans were not excepted from discharge under section 523(a)(8)(A)(i). Section 523(a)(8)(A)(i) excepts from discharge only loans or educational benefit overpayments made, insured or guaranteed by the government or a non-profit. Plaintiff's loans were not funded, insured, or guaranteed by any government or non-profit. Accordingly, Plaintiff's Non-Qualified Education Loans were not excepted from discharge under section 523(a)(8)(A)(i).

C. Plaintiff's Loans Are Not "qualified education loans" Under Section 523(a)(8)(B).

[14] *In re Renshaw*, 222 F.3d 82, 90 (2d Cir. 2000) ("[T]he exception to discharge of a debt in bankruptcy set out in § 523(a)(8) must be narrowly construed, with the burden of proof on the creditor colleges to prove the claims not dischargeable."); *Owens v. Owens,* 155 F. App'x 42, 43 (2d Cir. 2005) ("It is the creditor seeking an exception to discharge who bears the burden of proving facts coming within one of the § 523 exceptions."); *In re Horowitz*, No. 14-36884 (CGM), 2016 WL 1039581, at *4 (Bankr. S.D.N.Y. Mar. 15, 2016) ("In bankruptcy, the party objecting to discharge must prove its claim by a preponderance of the evidence. Although the standard of proof to prevail on a claim for non-dischargeability is a preponderance of the evidence, 'exceptions to discharge are to be narrowly construed and genuine doubts should be resolved in favor of the debtor.'").

Plaintiff's Non-Qualified Education Loans were not excepted from discharge under section 523(a)(8)(B) because they are not qualified education loans. Section 523(a)(8)(B) of the Bankruptcy Code excepts from discharge a "qualified education loan" as defined in section 221(d)(1) of the Internal Revenue Code. Section 221(d)(1) defines a "qualified education loan" as any indebtedness incurred by an *eligible student* solely to pay for "qualified higher education expenses." "Qualified higher education expenses" are in turn defined in section 221(d)(1) as expenses incurred to cover the "cost of attendance" at a Title IV eligible institution by an "eligible student." A Title IV eligible institution is one recognized by the Department of Education under Title IV of the Higher Education Act. "Cost of attendance" is term of art found in section 472 of the Higher Education Act at 20 U.S.C. § 1087ll that includes tuition, fees, room, board, books, and living expenses. All of these elements are necessary, and none are sufficient to render a debt instrument a qualified education loan.

Plaintiff's Loans were not qualified education loans because they were (SELECT ONE OR MORE OF THE BELOW OPTIONS):

(1) lent in excess of the "cost of attendance" as that term is defined in IRC 221(d):[15]

[15] Where part of a debt is used to cover qualified education expenses and part is not, the debt is a mixed-use loan, and therefore, not a qualified education loan. *See* IRS, 26 C.F.R. 1, REG-116826-97 ("Student I signs a promissory note for a loan which is secured by I's personal

- ACADEMIC TERM: Plaintiff's Cost of Attendance was $_______. Plaintiff received federal and state loans and grants totaling $_______. Plaintiff was eligible for an additional $______ in qualified private education loans. However, Defendant lent plaintiff $_______. Accordingly, the money was not used *solely* for qualified education expenses, and is not a qualified education loan.

(2) made to a student attending a non-Title IV accredited institution:

- ACADEMIC INSTIUTION: Plaintiff attended _____ between _____ and _____. ____was not a recognized institution under the Higher Education Act during those years, as demonstrated by the attached Exhibit A.

(3) made to an ineligible student:

- ACADEMIC TERM: Plaintiff attended ___ between ___ and ______. During that time, Plaintiff was not an eligible student pursuant to 20 U.S.C. 1019(a) because he/she was attending school less than half time.

Accordingly, Plaintiff's Non-Qualified Education Loans were not excepted from discharge under section 523(a)(8)(B).

D. Plaintiff's Loans Are Not "obligation[s] to repay funds received as an educational benefit" Under § 523(a)(8)(A)(ii).

Plaintiff's Non-Qualified Education Loans were not excepted under section 523(a)(8)(A)(ii) because they are not "obligations to repay funds received as an educational benefit, scholarship, or stipend." Creditors often disingenuously argue that where a loan was not made for qualified education expenses, the loan is

residence. Part of the loan proceeds will be used to pay for certain improvements to I's residence and part of the loan proceeds will be used to pay qualified higher education expenses of I's spouse. Because the loan is not incurred by I solely to pay qualified higher education expenses, the loan is not a qualified education loan.").

nonetheless excepted from discharge under section 523(a)(8)(A)(ii) as an "obligation to repay funds received as an educational benefit." However, this argument is without merit for at least three reasons. First, Congress did not use the word "loan" in section 523(a)(8)(A)(ii) but instead used the phrase "obligation to repay funds received." Second, this interpretation relies on the wrong definition of the homonym "benefit" and in so doing violate the canon of *noscitur a sociiss*. Third, this interpretation means that any debt made to any person for any educational purpose is non-dischargeable, which renders the other two subsections of 523(a)(8) superfluous and so violates the canon against superfluity (and the requirement to interpret exceptions to discharge narrowly).

1. Section 523(a)(8)(A)(ii) does not contain the word "loan" and courts cannot inject language into a statute that was intentionally left out by Congress.

Section 523(a)(8)(A)(ii) very conspicuously does not use the word "loan" but instead employs the phrase "obligation to repay funds received." While the two terms may have similarities, they are not interchangeable. Numerous courts have held that because Congress did not use the word "loan," section 523(a)(8)(A)(ii) cannot be used to except "student loans" from discharge. Rather, subsection 523(a)(8)(A)(ii) deals exclusively with defaulted conditional educational grants, such as VA benefits and ROTC scholarships. As the Ninth Circuit BAP reasoned in *Christoff:*

> [W]e agree with Debtor's counsel's statement at oral argument that § 523(a)(8)(A)(ii) is not a "catch-all" provision designed to include every type of credit transaction that bestows an educational benefit on a debtor. Instead, this subsection includes a condition, distinct from those in the other subsections of § 523(a)(8), that must be fulfilled . . . [i]n light of the many programs available to students which provide cash benefits to students, like veteran's educational benefits, stipends for teaching assignments, and cash scholarships, it is not absurd to assume that Congress intended the scope of § 523(a)(8)(A)(ii) to target obligations other than those arising from traditional student loans."[16]

Although the Ninth Circuit BAP made this determination without the aid of the legislative history, the legislative history proves their reasoning and logic was precisely correct. Legislative history demonstrates that Congress crafted the language in section 523(a)(8)(A)(ii) to cover defaulted conditional educational grants, not student loans. During testimony before the Subcommittee on Economic and Commercial Law, the drafter of the 1990 amendment to Section 523(a)(8) explained that the new section was designed to except from discharge defaulted governmental service obligations (debts which he specifically contrasted with "student loans") and cited a case demonstrating the need for this amendment.[17] Specifically, Mr. Wortham testified that:

[16] *Christoff v. Institute of Imaginal Studies* (*In re Christoff*), 527 B.R. 624, 634 (B.A.P. 9th Cir. 2015), *appeal dismissed* (Aug. 7, 2015)

[17] In the case cited in the legislative history, the debtor had defaulted on a PSASP medical school scholarship by failing to work in a physician shortage-area after graduation. The debtor thereby incurred an "obligation to repay funds received." Since this was not technically a "loan," the debtor then sought to discharge the obligation in bankruptcy since it was not within the literal scope of section 523(a)(8) at the time. Although the Eight Circuit refused to put form over substance and restricted discharge of the debt, Congress sought to remedy this potential for abuse

> This section [523(a)(8)] adds to the list of nondischargeable debts, obligations to repay educational funds received in the form of benefits (such as VA benefits), scholarships (such as medical service corps scholarships) and stipends. These obligations are often very sizeable and should receive the same treatment as a "student loan" with regard to restriction on dischargeability in bankruptcy. See U.S. Department of Health and Human Services v. Smith, 807 F.2d 122 (8th Cir. 1986) (parentheticals in original).[18]

In amending Section 523(a)(8) to except from discharge "an obligation to repay funds received as an educational benefit, scholarship, or stipend," Congress was addressing the dischargeability of conditional sums of money provided by the federal government, including "VA benefits"[19] and "medical service corps

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by inserting the "obligation to repay funds received as an educational benefit, scholarship, or stipend" language into section 523(a)(8).

[18] *See* Federal Debt Collection Procedures of 1990: Hearing on P.L. 101-647 Before the H. Subcomm. on Econ. and Commercial Law , H. Judiciary Committee 101st Cong. 74-75 (June 14, 1990) (Mr. Brooks' Questions for the Record from Mr. Wortham).

[19] An educational benefit, such as a VA benefit, may require repayment if the student defaults on a condition of the benefit, such as failing to achieve passing grades in a course being paid for by the VA. This default thus renders the educational benefit "an obligation to repay funds received as an educational benefit." *See United States v. Brandon*, 781 F.2d 1051, 1052 (4th. Cir. 1986) ("[T]he United States has a right of recovery against veterans who receive benefits and then fail to earn grades which count towards graduation.").

scholarships." Indeed, numerous courts have correctly applied the 1990 amendment to Section 523(a)(8) to debts for conditional service scholarships and stipends.[20]

2. **Interpreting "obligation to repay funds received as an educational benefit" to mean any loan that provides educational advantages violates the canon of *nosctiur a sociis***

Numerous courts across the country have recognized that a broad interpretation of section 523(a)(8)(A)(ii) is unworkable and inappropriate because it defies the cannon of *noscitur a sociis*. The cannon of *noscitur a sociis* states that where a word is included in a series, each word is presumed to have a similar meaning to each other. Accordingly, the words "benefit, scholarship, and stipend" as found in section 523(a)(8)(A)(ii) must be defined to give each word a similar meaning. Unlike the words "scholarship" and "stipend" whose meanings are obvious, the word "benefit" is a homonym that has two very distinct definitions. The first, "an advantage or profit gained from something." The second, "a payment made by an employer, an insurance company or the state." Since the other two words (scholarship and stipend) in section 523(a)(8)(A)(ii) are both types of

[20] *See, e.g.*, *Scott v. Midwestern Training Ctr., Inc. (In re Scott)*, 287 B.R. 470, 474 (Bankr. E.D. Mo. 2002) ("The third provision clearly has a plain meaning. It does not need to be construed broadly to except all loans for educational benefits from discharge. The provision grants protection to 'obligations to repay funds received as an educational benefit.' An example of such an obligation would be for funds provided as grants that must be repaid only under certain conditions (like the failure of a medical student grant recipient to practice in a physician shortage area after graduation)."); *Burks v. La., State of, & Bd. of Regents* (*In re Burks)*, 244 F.3d 1245, 1246 (11th Cir. 2001) (affirming nondischargeability of $30,000 worth of educational stipends awarded under the Louisiana Board of Regents' Graduate Fellowship Program for student who defaulted on his obligation to teach in minority school system after receiving his graduate degree).

"payments made by the state," it is necessary to interpret the word "benefit" in the same way. Accordingly, the word "benefit" should not be interpreted to mean "an advantage or profit gained from something" but instead "a payment made by the state." As Judge Craig more eloquently stated *Campbell v. Citibank, N.A., et. al.*

> [T]he canon of statutory construction known as *noscitur a sociis* instructs that when a statute contains a list, each word in that list presumptively has a similar meaning. To the extent that educational benefit (defined nowhere in the Bankruptcy Code) is ambiguous, it should be presumed to have a meaning similar to the other items in the list set forth in § 523(a)(8)(A)(ii). Scholarship and stipend both refer to funds which are not generally required to be repaid by the recipient. Therefore, in the absence of plain meaning to the contrary, or compelling legislative history, educational benefit must be understood to refer to something other than a loan, especially given that Congress uses the word loan elsewhere in § 523(a)(8). The concept which unites the three separate terms in the list in § 523(a)(8)(A)(ii) is that they all refer to types of conditional grants. (internal citations omitted).[21]

3. Interpreting "obligation to repay funds received as an education benefit" to mean any loan that provides educational advantages violates the cannon against superfluity.

Lastly, and most obviously, interpreting section 523(a)(8)(A)(ii) broadly to preclude discharge of any educational debt is illogical because it renders the rest of the statute superfluous. That is, if any educational debt is non-dischargeable under section 523(a)(8)(A)(ii), what reason did Congress have for crafting the other two subsections? Not only are those two sections superfluous, but the statute so

[21] *Campbell v. Citibank, N.A., et al*, (*In re Campbell*), 547 B.R. 49, 55 (Bankr. E.D.N.Y. 2016).

interpreted would mean that debt for any educational purpose—whether a fine at the local library, or a credit card charge for books on Amazon, or a past-due museum membership—would all be non-dischargeable under section 523(a)(8). This is clearly not what the statute was intended to accomplish.

Judge Randall Dunn of the District of Oregon recognized that such an interpretation of section 523(a)(8)(A)(ii) would violate the cannon against superfluity in *Nunez v. Key Educational Resources*:

> I see no basis to untether the language in § 523(a)(8)(A)(ii) to apply the student loan exception to discharge to "all obligations to repay funds received as an educational benefit, scholarship or stipend," without limitation. Such an interpretation would render § 523(a)(8)(B), the provision that Congress added to § 523(a)(8) in BAPCPA, superfluous and makes no sense. After all, if any educational loans of any kind are excepted from discharge by § 523(a)(8)(A)(ii), what addition does excepting qualified educational loans under the Internal Revenue Code make to the discharge exception? The educational loans excepted from discharge under § 523(a)(8)(B) would be no more than a subset of such loans already excepted from discharge under § 523(a)(8)(A)(ii).[22]

Likewise, in *Decena v. Citizens Bank,* Judge Grossman of the Eastern District of New York correctly concluded that "Section 523(a)(8)(A)(ii) is not a 'catch-all' provision designed to encompass any educational claim arising out of any transaction that bestows an educational benefit on a debtor."[23] Judge Grossman

[22] *Nunez v. Key Educational Resources* (*In re Nunez),* 527 B.R. 410, 415 (Bankr. D. Or. 2015).

[23] *Decena v. Citizens Bank* (*In re Decena),* 549 B.R. 11 (Bankr. E.D.N.Y. 2016) (reversed on other grounds).

stated that: “by focusing solely on the stated *educational purpose* giving rise to the debt – rather than the manner in which the debt arose – to qualify the debt under subsection 523(a)(8)(A)(ii), these cases effectively find that subsection 523(a)(8)(A)(i) is subsumed by subsection 523(a)(8)(A)(ii)”, and that this “interpretation also results in subsection 523(a)(8)(B) being subsumed by subsection 523(a)(8)(A)(ii), and renders subsection 523(a)(8)(B) superfluous.”[24] Judge Grossman also correctly concluded that “it defies logic to suggest that Congress added subsection 523(a)(8)(B) in 2005 to encompass a subset of loans already covered under subsection 523(a)(8)(A)(ii).”[25]

In June of 2016, the Bankruptcy Court for the Northern District of Ohio issued an order in *In Re Meyer* that also followed the line of reasoning set forth in *Decena,* stating that:

> [T]he Court is persuaded by Judge Grossman’s reasoning that subdivision (a)(8)(A)(ii) of section 523 refers to educational debts, other than loans, such as conditional grants and stipends that are not generally required to be repaid. *See Decena*, 549 B.R. at 20. The Court agrees with Judge Grossman than an expansive reading of section 523(a)(8)(A)(ii) would subsume and make unnecessary the separate subdivisions of section 523(a)(8)(A)(i) and (B). *See Decena*, 549 B.R. at 19. Nor is there any indication that the loans at issue in the current case were: (1) “made, insured, or guaranteed by a governmental unit” within the meaning of subdivision (a)(8)(A)(i) of section 523; (2) “made under any program funded in whole or in part by a governmental unit or nonprofit institution” within the meaning of subdivision (a)(8)(A)(i) of

[24] *Id.*

[25] *Id. See also Mackey v. Lanier Collection Agency & Serv., Inc.*, 486 U.S. 825, 836, 108 S. Ct. 2182, 2189, 100 L.Ed.2d 836 (1988) (expressing reluctance “to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law”).

> section 523; or (3) were "qualified educational loan[s]" within the meaning of subdivision (a)(8)(B) of section 523 and section 221(d)(1) of the Internal Revenue Code.[26]

The reasoning and legislative history set forth in *Campbell*, *Decena*, *Meyer*, *Nunez, Christoff, Schultz, Essangui, Dufrane, Kashikar*, *Wiley*, and *Matter of Megan Swenson* demonstrates the narrow scope of section 523(a)(8)(A)(ii).[27] Any argument that seeks to use section 523(a)(8)(A)(ii) as a "catch all" to capture and exempt the Plaintiff's Non-Qualified Educational Loans should be rejected.

Accordingly, the Plaintiff's Non-Qualified Educational Loans at issue in this action were not exempt from discharge in bankruptcy under any subsection of 523(a)(8), and were discharged in bankruptcy.

IV. CONCLUSION

For the above reasons, Plaintiff requests this court grant his motion for summary judgment, and declare that Plaintiff's non-qualified education loans were discharged upon entry of this Court's discharge order on _________.

---

[26] *In re Meyer*, No. 15-13193, 2016 WL 3251622, at *2 (Bankr. N.D. Ohio June 6, 2016).

[27] *In re Dufrane*, 566 B.R. 28, 37 (Bkrtcy.C.D.Cal., 2017); *In re Kashikar*, 567 B.R. 160, 167 (9th Cir. B.A.P. 2017); *In re Essangui*, 573 B.R. 614 (Bankr. D. Md. 2017); *In re Nunez,* 527 B.R. 410, 415 (Bankr. D. Ore. 2015); In re Decena, 549 B.R. 11, 20 (Bkrtcy. E.D.N.Y., 2016) (reversed on procedural grounds); *In re Schultz*, 2016 WL 8808073, at *1 (Bankr. D. Minn. 2016); I*n re Meyer*, 2016 WL 3251622, at *2 (Bankr. N. D. Ohio 2016; *In Matter of Swenson*, 2016 WL 4480719, at *3 (Bankr. W. D. Wis. 2016); *In re Wiley*, 2017 WL 6550418 (Bkrtcy.D.Me., 2017).

Dated this ___

Respectfully submitted,

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► In This Issue:

- Medical Bankruptcy Fairness Act of 2014
- The Misinterpretation of 11 U.S.C. § 523(a)(8)
- Student Debt Symposium

The Misinterpretation of 11 U.S.C. § 523(a)(8)

by Austin C. Smith

Bickel & Brawer
New York

[1]The common belief that all student loans are protected from discharge in bankruptcy is based on a misunderstanding of 11 U.S.C. § 523(a)(8). Since 1990, bankruptcy courts have been misreading the statute to prevent any student debt that could be construed as providing educational benefits or advantages from discharge. The flawed logic in student bankruptcy cases has thus become (1) all debts that confer educational benefits are protected from discharge; (2) the debt in question facilitated the debtor's education and as such, conferred educational benefits; and (3) the debt is not dischargeable. This application was never intended by Congress. Section 523(a)(8) currently protects from discharge:

> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
> (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
> (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986.

Importantly, each subsection of § 523(a)(8) addresses a different kind of debt, and practitioners cannot select useful terms from the many layers and so end by creating their own personalized version of § 523(a)(8). As the *In re Alibatya* court characterized this behavior, the "[d]efendant has sought to place [the] Plaintiff's ... obligation within virtually every category of excepted educational debt identified in 11 U.S.C. § 523(a)(8). Remarkably, at the same time, [the] Defendant blurs distinctions between such excepted categories, blending them under one overarching rubric, namely, educational benefit."[2]

However, the *Alibatya* court is almost unique in refusing this argument. Most bankruptcy courts have fallen victim to the *educational benefit* siren and have refused to discharge any debt that can be construed as providing broadly defined educational advantages. This interpretation is at odds with the statutory language and legislative history of § 523(a)(8), which protects three distinct classes of debt. First, subsection (A)(i) only protects federally insured or nonprofit student loans. Second, subsection (A)(ii) only protects debts resulting from noncompliance in contractual service scholarships and grants. Third, subsection (B) only protects *private* student loans that meet narrow Internal Revenue Code qualifications. A sizeable portion of private student loan debt falls outside all three of these categories, and must be treated as non-qualified private student loans that have no protection from discharge.

History of § 523(a)(8)

The history of § 523(a)(8) is closely tied to the federal government's commitment to higher education, which has two major programs. The first program offers federally insured, guaranteed or issued loans, such as the Stafford and Perkins loans.[3] The second program offers federal scholarships and grants, such as Veteran's Tuition Assistance and the National Health Service Corps Scholarship.[4] The impetus for § 523(a)(8) was largely to protect the government (and, by extension, the taxpayer) from students who took advantage of these programs to finance an education, and then filed for bankruptcy before moving onto lucrative careers.[5]

Since its initial enactment, there have been three major amendments[6] to § 523(a)(8). These amendments added (1) the provision excepting from discharge all federally guaranteed and nonprofit loans in 1979,[7] (2) the clause excepting from discharge all governmental service scholarships in 1990[8] and (3) the subsection excepting qualified private student loans from discharge in 2005.[9]

In its original incantation, § 523(a)(8) only protected federally guaranteed and nonprofit loan programs. The following language protected from discharge any debt that was

> (a)(8) for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a nonprofit institution of higher education....[10]

Notably, the original wording of § 523(a)(8) failed to address the potential problems that were created by federal scholarships and grants. In the 1980s, the issue was first raised as to whether debts resulting from service scholarships were protected by the original language in § 523(a)(8). [11] In *U.S. Dept. of Heath and Human Services v. Smith*, a student accepted a medical school scholarship on condition that he work in a "physician shortage" area for a certain number of years after graduation.[12] The student finished medical school but failed to satisfy the condition and thus incurred *an obligation to repay funds received as an educational … scholarship*. The student then filed for bankruptcy and sought to discharge the resulting obligation, arguing that the pre-1990 language in § 523(a)(8) rendered only *loans* nondischargeable. The bankruptcy and district courts held that the scholarship was not a loan, and therefore was dischargeable. However, the Eighth Circuit felt that a contingent scholarship debt was the near enough equivalent of a "loan" and reversed the lower court's decisions and prohibited discharge.[13]

Despite the Eighth Circuit's ruling, Congress was not entirely insensitive to this problem of interpretation and added a new clause to the existing statute, "or for an obligation to repay funds received as an educational benefit, scholarship, or stipend." The language after 1990 protected from discharge any debt:

> **(a)(8)** for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend....[14]

The new language was designed to remedy the problem of conditional scholarships and Congress even provided specific examples to illustrate the meaning of the new language. "This section [523(a)(8)] adds to the list of nondischargeable debts, obligations to repay educational funds received in the form of benefits (such as VA benefits), scholarships (such as medical service corps scholarships) and stipends. "[15] These examples offer critical evidence of congressional intent. For example, Congress used the word "benefit" to mean a VA benefit, which is incompatible with the broader interpretation of "benefit" as any money lent to further a debtor's education.[16]

The rise in commercial lending in the student loan market led for-profit lenders to seek similar protection from bankruptcy discharge.[17] Congress acquiesced, and in 2005, § 523(a)(8) underwent further changes. First, the statute's original provision was bifurcated into two subsections, §§ 523(a)(8)(A)(i) and 523(a)(8)(A)(ii). Second, subsection (B) was added to protect qualified private student loans from the discharge. After 2005, the language protected any debt for the following:

> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
> (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
> (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986.[18]

The Misinterpretation of § 523(a)(8)(A)(ii)

Despite the plain meaning of the statute and the legislative history, many courts have misread "obligation to repay funds received as an educational benefit" to mean that any loan that facilitates or furthers a debtor's education is protected from discharge. Inherent in this error is a misreading of two pieces of the statute: "obligation to repay funds" and "benefit." First, courts are substituting the word "loan" for the phrase "obligation to repay funds."[19] Second, the term "benefit" is being interpreted to mean those educational advantages provided by a student loan.[20]

However, a growing number of courts have realized the difficulty of the resultant logic: Interpreting "educational benefit" to except from discharge any loan that in any way facilitates education renders the remaining provisions of the statute meaningless. If any money lent to any person for any educational purpose is protected, then the remaining provisions of § 523(a)(8) — provisions carefully crafted to protect federally insured loans, nonprofit loans and other loans qualified by the IRC — become superfluous.[21]

The first error occurs when courts treat the phrase "obligation to repay funds" as synonymous with "loan." This occurred most notably in *In re Rumer*, in which the court created a summary of § 523(a)(8) that has been cited by later courts:[22]

> [Section] 523(a)(8) protects four categories of educational loans from discharge: (1) loans made, insured, or guaranteed by a governmental unit; (2) loans made under any program partially or fully funded by a government unit or nonprofit institution; (3) *loans received as an educational benefit, scholarship, or stipend*; and (4) any "qualified educational loan" as that term is defined in the [IRC].[23]

Notice how for the sake of symmetry, the *Rumer* court substituted the word "loan" for the phrase "obligation to repay funds" in the third part, thereby changing the meaning of the law. Benefits, scholarships and stipends are not loans. They are grants of money that are sometimes coupled with service obligations, which if not fulfilled result in an obligation to repay. Such conditional obligations may have attributes in common with loans, but the terms are not interchangeable.

Once the courts reclassified "obligation to repay funds" as "loans," they were forced to treat the phrase "educational benefit" as some sort of adjective-modifying loan. Thereafter, the whole focus of the analysis shifted from determining whether a debt *was an educational benefit* to determining whether the debt *was a loan that conferred education benefits*. This formula forged the words "loan" from subsection (A)(i) and "educational benefit" from subsection (A)(ii) into a single statutory chimera found nowhere in the statute's language. As a court in Michigan held, "the loans from Northstar are 'obligations to repay funds received as an educational benefit' under § 523(a)(8)(A)(ii)."[24] A Massachusetts court similarly held that "under the plain language of 11 U.S.C. § 523(a)(8)(ii), the August 2007 Agreement is a loan for an educational benefit."[25]

The Misapplication of § 523(a)(8)(B)

The problem with this misreading of § 523(a)(8)(A)(ii) is serious because it improperly serves as a catch-all provision to protect from discharge any and all debts that provide vaguely defined educational advantages. Now, some of the debts that are getting caught in the § 523(a)(8)(A)(ii) web might still be excepted from discharge under (1) § 523(a)(8)(A)(i) because they are federally insured or nonprofit loans, or (2) they might be excepted under § 523(a)(8)(B) because they are qualified private loans that meet the narrow IRC § 221(d)(1) qualifications.

However, IRC § 221(d)(1) sets forth specific requirements that are not met by every private student lender or loan. Subsection (B) protects only "qualified educational loans" (QEL) as defined in IRC § 221(d)(1). A QEL is defined as "any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses."[26] "Qualified education expenses" are in turn defined as "the cost of attendance at an eligible educational institution."[27] "Cost of attendance" is defined as "tuition, books and a reasonable allowance for room and board (as defined by the institution)."[28] The "cost of attendance" "as defined by the institution" must adhere to a federal methodology that calculates the full cost of attendance for a given school in a given area. No loans in excess of that calculated amount may be qualified.[29] Thus, any money lent to a student who has already reached his/her federal limit under the qualified "cost of attendance" is a nonqualified private student loan and has no protection from discharge under § 523(a)(8).

The problem arises when bankruptcy courts use the "educational benefit" language to bypass performing a thorough analysis of private student loans under the IRC. The most extreme example occurred in *In re Carow*.[30] In that case, a debtor sought to discharge her private student loans because they had been lent in excess of the qualified limits. "Dave Hanson ... the associate director of financial aid ... testified that [the] Debtor was awarded the maximum federal loan amount for which she was eligible and *that Chase's loans could not have been certified because they were above and beyond [the] Debtor's eligibility*."[31] The court disagreed, reasoning that even if the loan was in excess of federal limits, it was enough that the debtor had affirmed in the contract that the money would be used for qualified educational expenses.[32] However, the court hedged its holding and somewhat flippantly held that "[m]oreover, even if the loans were not a qualified educational loan as defined in 26 U.S.C. § 221(d)(1) for purposes of section 523(a)(8), subsection (a)(8)(A)(ii) provides that it is enough that the debt at issue be 'an obligation to repay funds received as an educational benefit.'"[33]

Conclusion

Since 1990, courts have misread the phrase "educational benefit" to protect from discharge any debt that has an *educational purpose* or otherwise furthered a debtor's educational pursuits. Such overbroad interpretations have abrogated the fresh start for thousands of debtors and provided commercial lenders with protections from discharge in circumstances that were never intended by the Bankruptcy Code. Nonqualified private student loans have no protection from discharge in bankruptcy. Furthermore, the

Consumer Financial Protection Bureau reported that more than 31 percent of student debtors between 2005-07 took out private loans in amounts that were not certified by the institutions.[34] This does not necessarily mean these loans are not qualified under the IRC — but with more than $150 billion in total outstanding private student loan debt, this issue demands closer scrutiny.

1. Special thanks to Prof. Lois R. Lupica (University of Maine School of Law; Portland, Maine), Bill Wilson and Marschall Smith. The views expressed in this article do not necessarily represent the views of Bickel & Brewer.

2. *In re Alibatya*, 178 B.R. 335, 338 (Bankr. E.D.N.Y. 1995).

3. Federal Student Aid, *Loans*, *available at* https://studentaid.ed.gov/types/loans (last visited May 20, 2014).

4. Federal Student Aid, *Grants and Scholarships*, *available at* https://studentaid.ed.gov/types/grants-scholarships (last visited May 20, 2014).

5. H.R. Rep. No. 95-595, at 133.

6. Space precludes a discussion of every amendment to § 523(a)(8). The three amendments discussed herein are the most significant to the issues addressed in this article.

7. P.L. 96-56 (Aug. 14, 1979).

8. P.L. 101-647, 104 Stat. 4789 (1990). This clause was later made its own subsection in 2005.

9. P.L. 109-8 (April 20, 2005).

10. *Supra* n.7.

11. *See also In re Lipps*, 79 B.R. 67 (Bankr. W.D. Fla. 1987); *In re Avila*, 53 B.R. 933, 937 (Bankr. W.D.N.Y. 1985).

12. 807 F.2d 122 (8th Cir. 1986).

13. *Id*. at 126-217.

14. *Supra* n.8.

15. Federal Debt Collection Procedure of 1990: Hearing on P.L. 101-647 Before the H. Subcommittee on Economic and Commercial Law, H. Judiciary Committee 101st Cong. 74-75 (June 14, 1990) (Mr. Brooks' Questions for the Record from Mr. Wortham).

16. The congressional record even cited *In re Smith* as impetus for the change.

17. 145 Cong. Rec. H2655-02, at Part 3 of 5 on WL (May 5, 1999) (this act was ultimately defeated in 1999, but language was subsequently incorporated into Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

18. *Supra* n.9.

19. *In re Rumer*, 469 B.R. 553 (Bankr. W.D. Pa. 2012); *In re Oliver*, 499 B.R. 617, n.3 (Bankr. S.D. Ind. 2013); *In re Beesely*, 2013 WL 5134404, at *3 (Bank. W.D. Pa. 2013).

20. Consider that the word "benefit" has two common meanings. The first is "an advantage or profit gained from something." The second is "a payment made by an employer, the state or an insurance company." Courts have been using the former, but Congress clearly intended the latter. *Oxford Dictionaries*, *available at* www.oxforddictionaries.com/us.

21. *See, e.g., London-Marable v. Sterling*, 2008 WL 2705374, at *5 (Bankr. D. Ariz. 2008); *see also In re Segal*, 57 F.3d 342, 348 (3d Cir. 1999).

22. *See supra* n.19; *but see In re Corbin*, 506 B.R. 287, 291 (Bankr. W.D. Wash. 2013), wherein the court cited the passage but corrected the error.

23. *In re Rumer*, 469 B.R. 553 (Bankr. M.D. Pa. 2012).

24. *In re Maas*, 497 B.R. at 863 (Bankr. W.D. Mich. 2013).

25. *In re Belforte*, 2012 WL 4620987 (Bankr. D. Mass. 2012).

26. 26 U.S.C. § 221(d)(1).

27. 26 U.S.C. § 221(d)(2).

28. 20 U.S.C. § 1087ll.

29. Mark Kantrowitz, "Limitations on Exception to Discharge of Private Student Loans," at 5 (March 5,

2009), *available at* www.finaid.org/questions/bankruptcylimitations.pdf; *see also* CFPB, Private Student Loans 10 (Aug 29, 2012), *available at* http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf.

30. 2011 WL 802847 (2011); *see also In re Skipworth*, 2010 WL 1417964 (Bankr. N.D. Ala. 2010); *In re Roy*, 2010 WL 1523996 (Bank. D.N.J. 2010); *In re Beesely*, 2013 WL 5134404 (Bankr. W.D. Pa.).

31. *In re Carow*, 2011 WL 802847 at *2 (2011) (emphasis added).

32.. *Id*. at *4.

33. *Id*.

34. CFPB, Private Student Loans 3 and 51 (Aug. 29, 2012), *available at* http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf (major culprit here are "direct-to-consumer" loans that bypass institutions altogether).

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Preparing for Trial in Bankruptcy Court: Tips and Best Practices

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Preparing for Trial in Bankruptcy Court:
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Todd Bartels and Andrew Nazar

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I. Preparing for Trial

A. Undisputed Facts

- What are the <u>elements</u> of your claims, counter-claims, and any defenses thereto
  - Have facts been determined by summary judgment
  - Facts undisputed based on responses to motions, answer, discovery
  - Can facts be narrowed by agreement of counsel
- Focusing facts down can save costs and time, and focus parties on what matters to decide and minimize risk that key facts are lost or not presented

B. Exhibits

- Counsel should prepare and maintain a chart of all of exhibits counsel may want to use (for any purpose) at trial.
- Parties should exchange exhibit lists and copies of any exhibits that the opposing party does not already have. The court may not permit counsel to offer an exhibit that was not on counsel's exhibit list.
- By including an exhibit on the list provided to opposing counsel without any qualification, counsel may be deemed to have waived any objections to the admissibility of that exhibit at trial. Accordingly, counsel should think carefully about each exhibit before including it on the list.
- Parties should exchange objections to each other's exhibit list. This can be done by adding a column to opposing counsel's exhibit list and filing in the column with a short hand for the objection (such as a reference to the applicable rule number in the Rules).
- Parties should meet and confer to attempt to consensually resolve any objections.
- Because there is no standard or rule related to the marking and numbering of exhibits across jurisdictions, it is important that the parties inquire, well in advance of trial or hearing, about the court's preferences.
- Most courts still want hard copies of all exhibits. If that is the court's preference, counsel should print (and organize into tabbed binders) all of the exhibits on counsel's own exhibit list (pre-marked, if permitted by the court).
- Finally, consider how you will use each exhibit at trial to support your case.

C. Witness Lists

- Witness lists typically required several days before smaller hearings, or in larger matters several months before, or during discovery.
- Witness list considerations
  - Have all witnesses been previously disclosed or identified in discovery?
  - If new witness listed, why now? Why not disclosed?

- Consider motion in limine if not disclosed – *See In re Paddock*, 533 B.R. 798, 801 (Bankr. D. Mont. 2015) (defendant prohibited from introducing evidence for failure to file witness and exhibit lists); *Miller v. Love's Travel Stops & Country Stores, Inc.*, CIV-06-1008-D, 2008 WL 2079957, at 1 (W.D. Okla. May 9, 2008) ("Pursuant to Fed.R.Civ.P. 37(c)(1), a party's failure to identify a witness in a timely manner may be excused if the failure was substantially justified or is harmless.")

- Also make sure to comply with local rules, court orders regarding any opinion, expert or fact designations
- Add any witnesses called for by any other party, or any witnesses necessary for rebuttal

D. Deposition Designations

- Counsel should work with opposing counsel to exchange (and set deadlines for exchanging) deposition designations, counter designations, counter-counter designations, and objections thereto.
- Generally, for each deposition in which testimony is designated, courts prefer to receive a single transcript with the cumulative designations of all parties highlighted therein. Parties should also endeavor to consensually resolve all objections to deposition designations ahead of trial.
- Some courts permit deposition designations to be shown by video. Counsel should consider whether there are any strategic advantages to doing so in the particular case and if so, have those video clips prepared.

E. Demonstrative Aids

- Help explain or visualize complex testimony to make it simple to understand
  - Note difference from demonstrative evidence vs. demonstrative aids – evidence – photographs, videos, recordings, charts, drawings – aids – witness asked to create during their testimony
- Not typically entered into evidence or marked as exhibit (not evidence itself, just helpful to the trier of fact)
- Note issues with jury trial and may want to get stipulation on admissibility before trial with opposing counsel

F. Technology

- Counsel should speak with the judge's courtroom deputy in advance of trial to understand the court's technological capabilities and requirements. This is particularly important if counsel wants to project or display exhibits or demonstratives on a screen or show deposition designations by video.

G. Motions in Limine

- Motions filed to exclude evidence or witnesses before the evidence or testimony is offered. Valuable as it provides the judge an opportunity to review the law and issue before the trial has started, where, typically they are more likely to just allow it to be entered, as they are the trier of fact.
- However they are advisory opinions and subject to change at trial – *US v. Yannott*, 42 F.3d 999, 1007 (6th Cir. 1994); *Euroholdings Capital & Inv. Corp. v.* Harris *Trust & Sav. Bank*, 602 F.Supp.2d 928, 935 (N.D. Ill. 2009); *but see* Hon. Barry Russell, Bankruptcy Evidence Manual 103:8 (2014 ed.) (reversing such decision may later constitute reversible error if there was reasonable reliance on such ruling).
- Typically raised for either expert issues or non-disclosure issues
- Should raise the specter of issues in pre-trial order, as some courts hold that failure to do so waives the issue (this is minority position) – *US v. Murray*, 492 F.2d 178 (9th Cir. 1978)
  - Can problem be easily cured? If so may wait until trial, or not file motion.
  - Deposition questions that were objected to, outside the scope of the 30(b)(6) designation.

II. Non-Testimonial Evidence

A. Introduction

- Non-testimonial evidence is evidence that does not come from testimony
- Three types: (1) real, (2) documentary, and (3) demonstrative
  - Example of real evidence – actual gun used in a bank robbery, real evidence is not common in bankruptcy (exception – value of car in parking lot)
  - Documentary – documents, contracts
  - Demonstrative – pictures, graphs, charts, recordings
- Fed. R. Evid. 403 – more prejudicial than probative – generally not a good objection in bankruptcy as judge is typically trier of fact, and they can decide what is prejudicial on their own, better objection cumulative, burdensome, already covered, etc.

B. Authentication

- Counsel must produce evidence sufficient to support a finding that the document is authentic or genuine; that is, that the document is "what the proponent claims it is." Fed R. Evid. 901(a).
  - The proponent of documentary evidence is only required to present prima facie evidence that it is authentic for it to be admitted in evidence.
  - The court's admission of the evidence does not represent a conclusive determination that it is authentic, and the non-proponent may present

conflicting evidence contesting the authenticity of the evidence. *See Ricketts v. City of Hartford*, 74 F.3d 1397, 1409–11 (2d Cir. 1996)

- In the absence of a stipulation between the parties, counsel should carefully consider before trial or hearing how he or she will establish that a document is authentic. Rules 803, 901(b), and 902 provide several ways to satisfy this requirement. Certain types of documents are "self-authenticating," meaning that "they require no extrinsic evidence of authenticity in order to be admitted." *See* Fed. R. Evid. 902.
- For nontestimonial evidence that is not self-authenticating, the Rules set forth a non-exhaustive list of the types of witness testimony and other evidence that can satisfy the authentication requirement.
  - Testimony of a witness with knowledge. Rule 901(b)(1)
  - Non-expert opinion about handwriting. Rule 901(b)(2)
  - Comparison by expert witness or the trier of fact. Rule 901(b)(3)
  - Distinctive characteristics and the like. Rule 901(b)(4)
  - Evidence about public records. Rule 901(b)(7)
  - Evidence about ancient documents or data compilations. Rule 901(b)(8)
  - Evidence about a process or system. Rule 901(b)(9)
  - Methods provided by a statute or rule. Rule 901(b)(10)
- <u>Through testimony of a witness with knowledge</u> – This is most common way to authenticate a document that is not self-authenticating.
  - When authenticating a document through such a witness, counsel should be prepared to "lay a foundation" establishing that the witness has personal knowledge of the document prior to offering the document into evidence. *See* Fed R. Evid. 602
- <u>Certified business records</u> - A common way to establish the authenticity of certain types of documents, particularly those of non-parties to the litigation, is as certified domestic records of a regularly conducted activity, commonly referred to as "certified business records." *See* Fed. R. Evid. 803(6) & 902(11).
  - When the relevant rules are followed, they overcome objections to both authenticity and hearsay. *See, e.g., In re Oak Rock Fin., LLC*, 560 B.R. 635, 640 (Bankr. E.D.N.Y. 2016) ("Because the documents are authentic as business records, they also are an exception to hearsay." (citing Fed. R. Evid. 803(6))).
- <u>Other types of self-authenticating documents</u> - Rule 902 provides that certain other types of documents are also self-authenticating and do not require the presence of a witness at trial to be admitted in evidence. They include:
  - Domestic public documents that are sealed and signed. Rule 902(1)
  - Domestic public documents that are not sealed but are signed and certified. Rule 902(2)
  - Foreign public documents. Rule 902(3)

    - Certified copies of public records. Rule 902(4)
    - Official publications. Rule 902(5)
    - Newspapers and periodicals. Rule 902(6)
    - Trade inscriptions and the like. Rule 902(7)
    - Acknowledged documents. Rule 902(8)
    - Commercial paper and related documents. Rule 902(9)
    - Presumptions under a federal statute. Rule 902(10)
    - Certified foreign records of a regularly conducted activity. Rule 902(12)
    - Certified records generated by an electronic process or system. Rule 902(13)
    - Certified data copied from an electronic device, storage medium, or file. Rule 902(14)102

C. Use of Duplicates in Lieu of Originals

- Fed. R. Evid. 1002: "To prove the content of a writing, recording, or photograph, the original writing, recording, or photograph is required, except as otherwise provided by these rules or by Act of Congress."
    - Sometimes referred to as the "Best Evidence Rule"
    - Simply means that if you are going to provide evidence of a writing, such as a contract, you should introduce the contract itself, not testimony as to what the contract said. *Bates v. Siggins (In re Siggins)*, Adversary No. 13-12716, 2014 WL 1796685 at 3 (Bankr. D. N.M. May 6, 2014).
- Sometimes witness may establish facts surrounding transaction without providing testimony regarding the contents of the writing or the contract. *In re United Tractors, Inc.*, 13 B.R. 239, 244 (Bankr. W.D. Mo. 1981) (testimony of facts concerning sale, recollection of sale price, and the lack of payments toward sale price not barred by "best evidence rule")
- Does that mean you always have to produce the wet-ink original? Rule 1003 "A duplicate is admissible to the same extent as an original unless (1) a genuine question is raised as to the authenticity of the original or (2) in the circumstances it would be unfair to admit the duplicate in lieu of the original."
    - To challenge a duplicate, must have an argument that calls the authenticity of original into question. Blank endorsement on note is insufficient. *In re Hattori*, Adversary No. 11-56789, 2012 WL 2061404 at 2 (Bankr. N.D. Cal. June 7, 2012).
    - A duplicate of a duplicate is still a duplicate. *Arkison v. Griffin (In re Griffin)*, 719 F.3d 1126, 1127 (9th Cir. 2013)

D. Completeness

- "Rule of completeness" – "If a party introduces all or part of a writing or recorded statement, an adverse party may require the introduction, at that time, of any other part or any other writing or recorded statement - that in fairness ought to be considered at the same time." Rule 106.

- The basic purpose of the rule is to permit the non-proponent to force the immediate introduction of contextual information to avoid any misleading impression on the fact-finder that would result from only select portions of the document being used. *See Rainey v. Beech Aircraft Corp*., 784 F.2d 1523, 1529–30 (11th Cir. 1986).

E. Judicial Notice

- Rule of Evidence 201 –

  (a) Scope. This rule governs judicial notice of an adjudicative fact only, not a legislative fact.
  (b) Kinds of Facts That May Be Judicially Noticed. The court may judicially notice a fact that is not subject to reasonable dispute because it:
    (1) is generally known within the trial court's territorial jurisdiction; or
    (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned.
  (c) Taking Notice. The court:
    (1) may take judicial notice on its own; or
    (2) must take judicial notice if a party requests it and the court is supplied with the necessary information.
  (d) Timing. The court may take judicial notice at any stage of the proceeding.
  (e) Opportunity to Be Heard. On timely request, a party is entitled to be heard on the propriety of taking judicial notice and the nature of the fact to be noticed. If the court takes judicial notice before notifying a party, the party, on request, is still entitled to be heard.

- Components
  - Generally **known** within the trial court's **territorial jurisdiction**
  - Accurately **and readily determined** from sources whose accuracy **cannot reasonably be questioned**.
  - Practice Tip from my Evidence Professor in law school – don't use judicial notice
- Issues Regarding Judicial Notice
  - Can take place at any time – Fed. R. Evid. 201(f), including appeal *Nantucket Investors II v. California Federal Bank (In re Indian Palms Associates),* 61 F.3d 197, 204 (3rd Cir. 1995).
  - Provided notice and basis met – it is mandatory, not permissive rule
  - Judicial notice may be taken by the court sua sponte, but the party against whom the judicially noticed fact is taken is entitled to a hearing and prior notice

i. Thus, for example, if a bankruptcy court implicitly took judicial notice, sua sponte, in considering the debtor's schedules in arriving at a ruling, on appeal, the matter may be remanded to allow the disadvantaged party to be afforded notice and opportunity to respond. *Annis v. First State Bank of Joplin*, 96 B.R. 917, 920 (W.D. Mo. 1987).
ii. Where judicial notice is taken without prior notice, the burden is on the disadvantaged party to make a request for a hearing to challenge the propriety of taking judicial notice. *Calder v. Job (In re Calder)*, 907 F. 2d 953, 955 fn. 2. (10th Cir. 1990).

- Examples
  - Debtor's insolvency or insolvency for a preference – can you introduce schedules showing debtor solvent on judicial admission and rest on that point? *See In re Trans air, Inc.*, 103 B.R. 322, 325 (Bankr. S.D. Fla. 1988); *Matter of Claxton*, 32 B.R. 219, 222 (Bankr. E.D. Va. 1983); *In re Blue Point Carpet, Inc.*, 102 B.R. 311, 320 (Bankr. E.D.N.Y. 1989). Better view is schedules cannot show it since it is only evidence as of petition date, not on the date of transfer. *In re Strickland*, 230 B.R. 276, 282 (Bankr. E.D. Va. 1999).
  - Docket Sheets - judicial notice of the docket sheets in an adversary proceeding and the debtor's main case. *Muzquiz v. Weissfisch*, 122 B.R. 56, 58 (Bankr. S.D. Tex. 1990); *See Mullis v. United States Bankruptcy Court*, 828 F.2d 1385, 1388 n.9 (9th Cir. 1987)
  - Schedules - *Calder v. Job (In re Calder)*, 907 F.2d 953, 955 fn. 2 (10th Cir. 1990) ("In this case, the bankruptcy court, consistent with Rule 201(b)(2), simply took judicial notice of the contents of …[the debtor's] Statement of Affairs and Schedule B-1 and not the truthfulness of the assertions therein.").

    i. Tip – are you offering it to show what the schedule says or doesn't say or prove the truth of the contents of the schedules. A previously filed court document will generally not be competent evidence of the truth of the matters asserted therein solely because the court has taken judicial notice of its existence. *Nantucket Investors II v. California Federal Bank (In re Indian Palms Associates)*, 61 F.3d 197, 204 (3d Cir. 1995); A bankruptcy court may not "infer the truth of facts contained in documents, unfettered by rules of evidence or logic, simply because such documents were filed with the court. *Staten Island Savings Bank v. Scarpinito (In re Scarpinito)*, 196 B.R. 257, 267 (Bankr. E.D. N.Y. 1996); *see also In re Earl*, 140 B.R. 728, 731 fn. 2 (Bankr. N.D. Ind. 1992).
    ii. Note difference between debtor offering his or her own schedules and creditor offering it as an admission under Fed. R. Evid. 801(d)(2).

III. Direct Testimony

A. General Rules and Strategy

- The object of direct examination is to establish the factual basis of a claim or defense. When preparing the examination, the questioning counsel must stand in as the surrogate for the fact-finder and develop questions that are necessary to elicit the necessary facts.
- Asking short, basic questions on direct examination helps keep the focus where it belongs during direct: on the testimony of the witness.
- Witness preparation is particularly important given that counsel is prohibited from asking leading questions on direct examination.
- There are generally three categories of information to elicit on direct examination:
  - First - <u>information that the fact-finder needs to know</u>. The essential evidence proves or disproves the elements of the cause of action. The party with the burden of proof must focus on evidence that supports the allegations; the defending party's direct case must incorporate evidence that contradicts the elements or establishes an affirmative defense.
  - Second - <u>information that the fact-finder would like to know</u> — not essential but contextual. For example, the motives behind a particular transaction may not be necessary information for the fact-finder, but they are often of interest. Such context makes a direct case compelling and interesting.
  - Third - <u>information that would normally be part of the narrative but that, for some reason or another, will not be introduced</u>. Rather than simply pretend that this omission does not exist, counsel should plan for direct testimony that explains or minimizes the impact of such a hole in the narrative.
- With each of these categories of information, counsel should anticipate the cross-examination. In doing so, counsel may enhance and add credibility to counsel's own case and simultaneously mitigate the opposition's ability to control the narrative.
- Counsel should likewise be prepared to respond to any reasonable objection. A witness outline should provide counsel with the tools to address an objection.
- For key witnesses, counsel's preparation should also include preparing the witness by going over the questions counsel intends to ask on direct, anticipated cross-examination questions, answers, and objections.

B. Declaration and Proffers

Rule of Civil Procedure 43(a) (applicable by Fed. R. Bankr. P. 9017) – testimony orally in open court, unless otherwise provided by other rule. Fed. R. Evid. 611 gives court authority to control manner and format of presentation of evidence.

Usually in form of a declaration under penalty of perjury – appellate courts have accepted direct testimony in bankruptcy matters, provided the declarant is in the court room and can be cross examined (otherwise hearsay) – see *In re Adair*, 965 F.2d 777, 779 (9th Cir. 1992)

Attorney proffer for first day hearings, non-contested confirmations, but should have witness prepared if an objection is made.

C. Other Testimonial Issues

- If a witness asserts she or he does not know the answer to a question and a record exists that demonstrates otherwise, counsel may impeach the witness through use of a past recollection recorded. Rule 803(5).
- An adverse party may also use a writing to refresh the witness's memory. Rule 612(a).
    - In using a writing to refresh a recollection, the party must produce the writing at the hearing, permit its inspection, and allow the witness to be cross-examined on the writing.
    - It is not necessary that the document used to refresh the witness's recollection itself be admissible. It is the recollection that is being offered, not the re-minder.
    - As a result, it is proper practice to take the writing away from the witness before she or he continues to testify.
- Routine business practice - Establishing a person's habit or an entity's routine business practice is often important in bankruptcy cases.
    - Evidence of a person's habit or an organization's routine practice may be admitted to prove that on a particular occasion the person or organization acted in accordance with the habit or routine practice. The court may admit this evidence regardless of whether it is corroborated or whether there was an eyewitness. Rule 406.
    - For example, evidence of a routine practice may establish an ordinary course of business defense to a preference action, the historical cash management system of the company as part of a "first day" cash management motion or employee wage motion, or feasibility of a plan at the confirmation hearing.
- Parol evidence rule - "a rule of substantive contract law and not a rule of evidence." *Liquidating Trust of Texas Gen. Petroleum Corp. v. McFarland & Tondre (In re Texas Gen. Petroleum Corp.*), 122 B.R. 306, 308 (Bankr. S.D. Tex. 1990), aff'd, 40 F.3d 763 (5th Cir. 1994), cert. denied, 514 U.S. 1128 (1995), opinion recalled and superseded by 52 F.3d 1330 (5th Cir. 1995).
    - The parol evidence rule is governed by state law. *In re Commercial Money Ctr., Inc*., 350 B.R. 465, 474 (B.A.P. 9th Cir. 2006).

- It generally provides that the interpretation of a contract should be limited to the text of the contract, and forbids the use of evidence of prior or contemporaneous negotiations and agreements to contradict, modify, or vary the contractual terms of a written contract when the written contract is intended to be a complete and final expression of the parties' agreement.
- The extent, validity, and priority of a secured party's interest in property of the debtor's estate can be a critical issue in a bankruptcy case. Parties challenging or defending the secured party's interest may seek to introduce evidence beyond the four corners of a note, security agreement, or deed of trust (i.e., parol evidence).

- Lay opinion testimony - While the testimony of non-experts is generally limited to factual observations, a lay opinion may be provided in certain limited situations.
  - Lay opinions of value are common in individual and small business bankruptcy cases to establish the value of an asset for various purposes, including adequate protection, asset sales, or relief from stay motions.
  - The subject of the lay opinion must be either a matter as to which one presumes all adults have sufficient experience or a matter as to which the lay person has special knowledge.
  - The most common situation in the latter category is the value of land or property. For example, the owner of property is generally treated as having such special knowledge. *See Asplundh Mfg. Div. v. Benton Harbor Eng'g*, 57 F.3d 1190, 1196–98 (3d Cir. 1995) (lay opinion of value of one's property as "quintessential Rule 701 opinion testimony").
  - Rule 701 sets forth the permissible scope of opinion testimony by lay witness. It provides:
    - If a witness is not testifying as an expert, testimony in the form of an opinion is limited to one that is:
      (a) rationally based on the witness's perception;
      (b) helpful determining a fact in issue; and
      (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702.
  - Rule 602 provides that witness testimony must be based on personal knowledge, and the only exception to that Rule is expert testimony under Rule 703.
  - Accordingly, to be admissible, a lay opinion must be based on the witness's personal knowledge and may not be based on inadmissible hearsay. *See United States v. Freeman*, 498 F. 3d 893, 904 (9th Cir. 2007).

D. Hearsay

- Rule 802: "Hearsay is not admissible except as provided in these rules…"

- Rule 801: - Definitions
  - "'Hearsay' is a statement, other than the one made by the declarant while testifying at trial or hearing, offered in evidence to prove the truth of the matter asserted."
  - "A "statement" is (1) an oral or written assertion or (2) nonverbal conduct of a person, if it is intended by the person as an assertion."
- Rule 801(d): - Definitional exclusions. The following are not hearsay, even though they technically meet the definition of 801(c):
  - Prior inconsistent statement of the witness (impeachment)
    1. must be inconsistent with testimony at trial; and
    2. must have been given under oath or penalty of perjury.
  - Prior consistent statement (rehabilitation)
    1. must be consistent with testimony at trial; and
    2. must be used to rebut an express or implied charge of recent fabrication, or improper influence or motive.
  - Identification of a person
  - Admission by a party-opponent
    1. Must be offered against the party; and
    2. Is either the party's own statement, one that the party has adopted, was authorized by the party, was made by the party's agent, or was made by a coconspirator.

E. It's hearsay, but is there an exception?

- Rule 803 – Exceptions where status of declarant irrelevant
  - present sense impression
  - then existing mental, emotional, or physical condition
  - recorded recollection
  - records of regularly conducted activity
  - records of documents affecting an interest in property
- Rule 804 – Exceptions, but declarant must be unavailable
  - "Unavailable" defined to include: refusing to testify concerning statement despite order to do so; lack of memory; physical, mental illness or infirmity; absent from hearing and attendance cannot be procured.
  - If the declarant is unavailable, the following may be offered even though technically hearsay:
    1. Former testimony (under oath and subject to cross examination)
    2. Statement under belief of impending death
    3. Statement against interest
    4. Statement of personal family history
- Rule 807 – Residual Exception

- Allows court to admit hearsay evidence, even if no other exception applies, where:
  i. the statement is offered as evidence of a material fact;
  ii. the statement is more probative of the point than any other evidence which the proponent can procure through reasonable efforts;
  iii. general purposes of the rules and the interests of justice will be best served by admitting the statement.
- The proponent must give sufficient advance notice to opposing party in order to provide the adverse party with a fair opportunity to meet it, which notice includes the name and address of the declarant.

F. Common Uses of Hearsay Evidence

- Admission of Party Opponent (801(d)(2)) vs. Statement Against Interest (804(b)(3)).
  - Attorneys sometimes confuse whether a hearsay statement is being offered as an admission of a party opponent or whether the statement is being offered as a statement against interest. Which rule applies depends on the facts:
    i. Is the declarant a party? If not, 801(d)(2) does not apply.
    ii. Is the proponent of the party admission also the party who made the out of court statement? If so, 801(d)(2) will not apply.
    iii. If not a party, is the declarant available? If so, then 803(b)(3) will not apply.
  - Potential types of statements/documents: schedules, financial statements, affidavits, recorded statements, deposition testimony.
  - Appraisal commissioned by secured creditor was not an admission of a party opponent. *In re CGR Investors Ltd. P'ship*, 464 B.R. 678, 680 (Bankr. E.D. Pa. 2010).
- Recorded Recollection (803(5)) not admitted as an exhibit.
  - Parties may seek to introduce hearsay evidence under 803(5) by arguing it is a note or memo that the declarant made regarding something that the declarant wanted to remember.
  - Key points:
    i. must concern a matter that the witness who is testifying once knew, but now cannot remember;
    ii. statement is one what was made or adopted when the information was fresh in the witness' memory
    iii. the information in the recorded recollection may be read into evidence, but the proponent cannot actually offer the document into evidence. (adverse party can offer it) *In re Wilson*, Adversary No. 04-9016, 2004 WL 2671678 at *2 (Bankr. N.D. Iowa, Nov. 12, 2004).

- Helpful to refresh recollection, however recording must be shown to opposing counsel

- Business Records (803(6)) and what constitutes a "business record"
  - Several elements to what constitutes a "business record". *In re New Jersey Mobile Dental Practice, P.A.*, Adversary No. 10-02067, 2012 WL 3018052 at *7 (Bankr. D. N.J. 2012)
    - i. made at or the time of event or information recorded;
    - ii. by a person with knowledge
    - iii. kept in the course of a regularly conducted business activity;
    - iv. the regular practice of the business activity is to make the memorandum or report,
    - v. as established by the custodian or other qualified witness.
  - Does not cover every document in business's possession.
    - i. Just because a document is in a business's file does not make that document a business record. *In re Bay Vista of Virginia, Inc.*, 428 B.R. 197, 212 (Bankr. E.D. Va. 2010).
    - ii. not only kept in the course of business, must also be the regular practice to make the report – one off reports probably not sufficient.
    - iii. must establish <u>every</u> element. *In re Mobile Dental, supra*.
  - Record must be created by the business whose record it is.
- Former Testimony (804(b)(1)) and whether admissible.
  - Biggest stumbling block for lawyers is confusing with 801(d)(2) or offering prior deposition testimony where witness is testifying or is available to testify.
    - i. if prior testimony is a party-opponent and the testimony is being offered against that party, 801(d)(2) applies and the testimony is not hearsay. *In re Medez*, Adversary No. 06-1111, 2008 WL 597280 at *8 (Bankr. E.D. Cal. Feb. 29, 2008).
  - To admit former testimony from prior hearing or deposition, the declarant must be unavailable (unless impeaching). *In re Jenkins*, 258 B.R. 251, 258 (Bankr. N.D. Ala. 2001).
  - If witness is not a party, 801(d)(2) will not apply.

IV. Cross Examination

A. Strategic Consideration

- Control of the witness through presentation and form of question is key with leading questions – few cases are won on cross-examination
- Be ready with deposition marked ready to impeach
- Carefully script questions to make sure any question cannot be reasonably disputed

1. Raise questions about credibility of witness

2. Bring additional or clarifying facts
3. Hard to introduce documents through cross-exam, so try and think about other ways to do it.

B. Expert Witness

- In preparing to cross-examine an expert, counsel should thoroughly investigate the experts' qualifications and prior experience as an expert witness.
- Other useful techniques in cross-examining an expert witness include (a) identifying assumptions that the expert made, (b) identifying facts and information that the expert did not consider in formulating his or her opinion, and (c) highlighting flawed aspects of the expert's methodology. Counsel should *not* attempt to get the expert witness to admit that anything he or she did was incorrect. Counsel's own expert can do that.

V. Objections

A. When to Object

- Must be quick and should be something they cannot easily fix and is material to the case
- Prepare in advance for key evidence that is objectionable (consider motion in limine if complicated)
- Object to objectionable questions that are relevant, even if judge asks them

B. Appellate Preservation

- Rule 103 provides what counsel must do to preserve a claim of error with respect to an evidentiary ruling.
- If counsel seeks to exclude evidence, objecting (or timely moving to strike) is necessary to create a record of appeal. *See* Fed. R. Evid. 103(a)(1); *see also* Fed. R. Civ. P. 46 (providing that a party seeking to preserve an objection to a court's ruling must "make[e] known to the court the action which they party desires the court to take or the party's objection to the action of the court and the grounds therefor"). The objection must state the specific ground, unless it is readily apparent from the context. *See* Fed. R. Evid. 103(a)(1); *see also United States v. Polasek*, 162 F.3d 878, 883 (5th Cir. 1998) ("A loosely formulated and imprecise objection will not preserve error.").
- If counsel seeks to admit evidence and the court excludes it, an offer of proof is required to presser the issue for appeal unless the substance clear from the record, either explicitly or through context. *See* Fed. R. Evid. 103(a)(2) ("A party may claim error in a ruling to . . . exclude evidence only if the error affects a substantial right of the party and . . . a party informs the court of [the rejected evidence's]

substance by an offer of proof, unless the substance was apparent from the context.”).

VI. Experts

A. Employment

- Remember debtors may need to file motion to employ expert – While there is no majority rule as to whether expert witnesses fall within “other professional persons” of § 327, courts have been almost unanimous in looking to the subject matter of the expert's testimony and evaluating how closely such matter is related to core bankruptcy issues – *In re Cyrus II Partnership*, 2008 WL 3003824 (Bankr. S.D. Tex. 2008)
- Examples - *See In re Artra Group, Inc.*, 308 B.R. 858 (Bankr. N.D. Ill. 2003) (expert employed by debtor for pre-petition litigation involving insurance proceeds did not need to be employed as he did not have any autonomy or discretion with respect to administration of the estate; *In re Dunhill Resources, Inc.*, No. 03-41264-H2-11 (Bankr.S.D.Tex. Apr. 5, 2005).

B. Expert Qualifications

- Only “[a] witness who is qualified . . . by knowledge, skill, experience, training, or education may testify in the form of an opinion . . . .” Fed. R. Evid. 702.
- Under Rule 104(a), the trial judge makes a preliminary determination on a witness’s expert qualifications before substantive testimony is adduced.
- The testimony must be helpful.
  - While the “helpfulness” standard must be determined on a case-by-case basis, several examples illuminate how trial courts approach this determination. For instance, courts often find expert testimony on the issues of solvency and value helpful. *See, e.g., Tronox, Inc. v. Kerr McGee Corp.* (*In re Tronox, Inc.*), 503 B.R. 239 (Bankr. S.D.N.Y. 2013) (solvency); *United States v. Kayne*, 90 F.3d 7 (1st Cir. 1996) (value).
  - Similarly, expert testimony on the issue of damages is generally determined to be helpful. *See, e.g., Andler v. Clear Channel Broad., Inc.*, 670 F.3d 717 (6th Cir. 2012); *Salas by Salas v. Wang*, 846 F.2d 897 (3d Cir. 1988); *McGowne v. Challenge-Cook Bros., Inc.*, 672 F.2d 652 (8th Cir. 1982).
  - By contrast, expert testimony on the issue of the reasonableness of professional fees in a bankruptcy case often does not satisfy the helpfulness standard. *See, e.g., Boleman Law Firm, P.C. v. U.S. Tr.*, 355 B.R. 548 (E.D. Va. 2006); *In re MiniScribe Corp.*, 241 B.R. 729 (Bankr. D. Colo. 1999); *In re W.J. Servs., Inc.*, 139 B.R. 824 (Bankr. S.D. Tex. 1992); *In re Terex*, 70 B.R. 996 (Bankr. N.D. Ohio 1987).

- In many types of contested matters and adversary proceedings, it may be helpful to the fact-finder to hear expert testimony in support of key elements of claims and defenses. For instance, in a contested chapter 11 plan confirmation matter, expert testimony about the appropriate cram-down interest rate may help ensure that the claimant receives plan payments totaling the present value of the secured claim. *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II).
- In a stay relief matter, expert testimony about the valuation of collateral may assist the court in determining whether the lienholder is adequately protected or whether the debtor has equity in the property. *See* 11 U.S.C. § 362(d).
- In a preference action, expert testimony may be useful regarding whether a transfer occurred according to ordinary business terms or in the ordinary course of business between the parties. *See* 11 U.S.C. § 547(c)(2).

- In addition to finding the expert to be qualified and his or her testimony to be helpful, the trial court must also determine that the testimony is reliable.
  - The reliability requirement includes several parts:
  - First, the trial court must determine that the expert's opinion has a sufficient basis, and thus it is not speculative. *See Samuels v. Holland Am. Line-USA, Inc.*, 656 F.3d 948 (9th Cir. 2011); *Zamecnic v. Indian Prairie School Dist. No. 204*, 636 F.3d 874 (7th Cir. 2011). In the parlance of Rule 703, the proper bases for expert testimony are "facts and data" that: (a) the expert has been made aware of or personally observed before trial, *See, e.g., Simmons v. Chicago and Northwestern Transp. Co.*, 993 F.2d 1326 (8th Cir. 1993) (opinion based on physical evidence); *United States v. Hill*, 655 F.2d 512 (3d Cir. 1981) (opinion based on observation); (b) the expert has been made aware of or personally observed at trial, *See, e.g., Hill v. Reederei F. Laeisz G.M.B.H.*, 435 F.3d 404 (3d Cir. 2006) (expert may rely on information observed at trial); *see also United States v. Seale*, 600 F.3d 473 (5th Cir. 2010) ("Fed. R. Evid. 703 contemplates that an expert may base his opinion on facts or data presented at trial."); or (c) are the type of facts or data that an expert in field would reasonably rely on. *See, e.g., Ramsey v. Culpepper*, 738 F.2d 1092 (10th Cir. 1984). The bases for the expert's opinion need not be otherwise admissible. *See Ambrosini v. Labarraque*, 966 F.2d 1464 (D.C. Cir. 1992); *Kingsley Assocs., Inc. v. Del-Met, Inc.*, 918 F.2d 1277, 1286–87 (6th Cir. 1990); *Am. Universal Ins. Co. v. Falzone*, 644 F.2d 65 (1st Cir. 1981).
  - Second, the trial court must determine that the opinion is the product of reliable principles and methods. In the context of scientific evidence, at least, key questions as to the reliability of the method ology include: (a) whether the theory or technique can be and has been tested, (b) whether it has been subjected to peer review/publication, (c) the rate of error, (d) the existence of standards governing operation of the technique, and (e) the degree of acceptance in the

scientific community. Since Daubert, courts of appeals have expanded the list of issues that may be considered in determining whether an expert opinion is the product of reliable methodology, although many of the factors are merely restatements of, and overlap with, the factors set forth in Daubert.

  - Finally, assuming that the facts and data are sufficient and the expert is utilizing reliable principles and methods, the final question is whether the expert properly applied the principles and methods to the facts and data in forming the opinion. *See* Fed. R. Evid. 702(d); *see also Adams v. Lab. Corp. of Am.*, 760 F.3d 1322 (11th Cir. 2014); *Amorgianos v. Nat'l R.R. Passenger Corp.*, 303 F.3d 256 (3d Cir. 2003).

- Once a witness is qualified, the strength of the qualifications goes to the weight and credibility that the fact-finder accords the testimony, not to its admissibility. *See Fox v. Dannenburg*, 906 F.2d 1253 (8th Cir. 1990); *Alberts v. HCA, Inc.*, 496 B.R. 1 (D.D.C. 2013); *In re Hernandez*, 493 B.R. 46 (Bankr. N.D. Ill. 2013); *In re 3dfx Interactive*, 389 B.R. 842 (Bankr. N.D. Cal. 2008); *In re Lona*, 393 B.R. 1 (Bankr. C.D. Cal. 2008); *In re Westminster Assocs., Ltd.*, 265 B.R. 329 (Bankr. M.D. Fla. 2001); *In re Smith*, 267 B.R. 568 (Bankr. S.D. Ohio 2001); *In re Piece Goods Shops Co., L.P.*, 188 B.R. 778 (Bankr. M.D.N.C. 1995); *In re Robertson*, 135 B.R. 350 (Bankr. E.D. Ark. 1992); *In re Julien*, 127 B.R. 604 (Bankr. W.D. Tenn. 1991); *In re 1616 Reminc L.P.*, 9 B.R. 679 (Bankr. E.D. Va. 1981).

C. Rule 26 - Contested Matters and Adversary

- Remember differences between contested matters under Fed. R. Bankr. P. 9014 and adversaries under Fed. R. Bankr. P. 7000, et al. Under Fed. R. Civ. P. 9014(c) – expert rules under Fed. R. Civ. 26(a)(2) don't apply unless court orders otherwise.

Chapter 11: Greatest Hits and One-Hit Wonders

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Debtor-in-Possession Financing Orders; Intercreditor Agreements; and Aggressive Secured Creditors Holding Subordinate Debt

1. **Golden Shares / Bankruptcy Blocking Provisions**

   a. What is a "golden share" and why does it matter?

      i. According to the Fifth Circuit – "as used in the bankruptcy context, the term generally refers to the issuance to a creditor of a trivial number of shares that gives the creditor the right to prevent a voluntary bankruptcy petition, potentially among other rights." (citations omitted) (emphasis added). *In re Franchise Servs. of N. Am., Inc.*, 891 F.3d 198, 205 (5th Cir. 2018), *as revised* (June 14, 2018).

      ii. Corporation is a qualified debtor under Chapter 11 and may file a voluntary petition. *See* 11 U.S.C. § 109(a)-(b),(d); 11 U.S.C. § 301. A corporation cannot act on its own, and can only act if duly authorized.

      iii. State law determines who has the authority to file a voluntary petition on behalf of the corporation. So, the governing corporate documents and their enforceability under state law are very important.

      iv. Authority to file a bankruptcy petition is treated by the Eighth Circuit as a jurisdictional issue. *See Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255, 1259 (8th Cir. 1994). As such, once the bankruptcy court finds authority lacking, it must dismiss. *Price v. Gurney*, 324 U.S. 100, 106 (1945).

         (1) Presumably, jurisdictional considerations allow this issue to be raised any time.

         (2) *Cf.* 11 U.S.C. § 1112(b), which assumes the bankruptcy court has jurisdiction but recognizes other reasons justifying dismissal, such as bad faith.

      v. Common "golden share" structures:

         (1) Blocking Shareholder/Partner: Creation of ownership class whose vote is required for voluntary filing;

         (2) Blocking Director: Creation of entity (usually, SPE) with a governance body that includes a representative of the lender (who often has no operational involvement), but placed and directed to defeat unanimous vote for voluntary bankruptcy filing

   b. Case law considering golden share and blocking provisions – most courts deem void as against public policy

i. Courts generally hold that a contractual pre-petition waiver of the right to file for bankruptcy is contrary to federal law and therefore void

ii. Mostly, these cases deal with a lender conditioning forbearance on an amendment to the entity's foundational documents that grants the lender a bankruptcy veto right, or, a contractual bankruptcy waiver.

iii. *In re Bay Club Partners-472, LLC*, Case No. 14-30394, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014). Court denied motion to dismiss where lender requested provision in operating agreement that prohibited the filing of a voluntary bankruptcy petition before all debts were paid in full.

- Debtor received a loan to finance the purchase of a large apartment complex. Lender requested that a bankruptcy waiver provision be added to the debtor's operating agreement.

- Lender had no equity interest in the debtor.

- Provision stated that the debtor "shall not institute proceedings to be adjudicated bankrupt or insolvent" until "the indebtedness secured by that pledge [of the acquired property] is paid in full." *Id.*

iv. *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016). Court denied motion to dismiss where lender conditioned forbearance on appointment of lender as non-fiduciary "special member" with right to prevent bankruptcy but without right to distributions or obligation to make capital contributions.

- Debtor amended its operating agreement to make lender a member of the debtor.

- As a member, the lender had the right to approve or disapprove of any "Material Action" (defined to include bankruptcy proceedings).

- Lender had no interest in the profits or losses of the debtor, no right to distributions, no tax consequences, and was not required to make capital contributions.

- According to the court, the lender "was kept separate and apart from the Debtor in all ways but for its authority to block the Debtor from petitioning for bankruptcy relief."

- Court explained that in order to have an acceptable "blocking director structure," the blocking director "must be subject to normal director fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor that they were chosen by."

- Allowing lender to contract for control of a debtor's decision whether to file a bankruptcy petition undermines the most fundamental purposes of bankruptcy law.

v. *In re Intervention Energy Holdings, LLC*, 533 B.R. 258 (Bankr. D. Del. 2016). Court denied motion to dismiss where lender conditioned forbearance on issuance of single common unit to lender, plus amendment of operating agreement to require unanimous consent of interest holders for voluntary bankruptcy filing.

- Debtor defaulted and agreed to make the lender a common member if the creditor agreed to waive defaults.

- Debtor amended its operating agreement to require unanimous consent from its members to file for bankruptcy. The debtor issued 22,000,001 "Common Units" to interest holders; lender held 1 Common Unit (acquired for $1).

vi. *In re Lexington Hospitality Group, LLC*, Case No. 17-51568, 2017 WL 4118117 (Bankr. E.D. Ky. Sept. 15, 2017). Motion to dismiss denied where lender conditioned financing on grant of equity interest and appointment of non-fiduciary blocking director with right to prevent bankruptcy.

- *Additionally,* the LLC's governing documents directed the blocking member to consider only the creditors' interests

vii. ***But see In re Squire Partners Limited Partnership*, 574 B.R. 701 (E.D. Ark. 2017)**, *appeal dismissed sub nom., Squire Court Partners Ltd. P'ship*, No. 17-2700, 2018 WL 654419 (8th Cir. Jan. 5, 2018). Court granted motion to dismiss where debtor's partnership agreement required the unanimous consent of partners for a bankruptcy filing. The sole general partner was unable to obtain the consent of the two limited partners.

- General partner and its affiliate argued that the unanimous consent provision is void as a matter of federal public policy. They argued that federal public policy provides that *only a fiduciary* may decide whether an entity will or will not seek relief under the bankruptcy code.

- They argued the limited partners were unable to act in the best interests of the partnership because of a conflict of interest due to their contribution obligations and enforcement of a guaranty agreement.

- Court found it significant that the limited partners were *owners*, not creditors of the debtor (one limited partner held .01% interest, and the other held 99.98% interest; neither consented to the bankruptcy filing).

"It is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor's decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy. It is one thing for the courts to overrule a creditor that seeks to block a debtor from filing bankruptcy; it is quite another for the courts to overrule the owners of the entity. *Squire Court*, 574 B.R. at 708.

Fifth Circuit Declines to Address the General Legality of Blocking Provisions and Golden Shares and Whether Delaware Law Would Allow a Blocking Provision – *In re Franchise Servs. of N. Am., Inc.*, 891 F.3d 198 (5th Cir. 2018), *as revised* (June 14, 2018)

FACTS:

- Debtor was one of the largest car rental companies in North America

- Its competitor, Hertz Corp., was seeking to merge with Dollar Thrifty Automotive Group but antitrust concerns caused it to sell one of its subsidiaries – Advantage Rent-A-Car

- Debtor wanted to buy Advantage and hired investment bank Macquarie Capital to assist

- Macquarie's subsidiary would buy Advantage, then merge with the Debtor, which it did

- Macquarie created another wholly-owned subsidiary, Boketo, LLC, to help finance the transaction (Macquarie was a creditor of the debtor by virtue of the arrangement and financial advisory fees in connection with the transaction)

- Boketo made a $15MM investment in the debtor, in exchange for which the debtor gave Boketo 100% of its preferred stock (in the form of a convertible preferred equity instrument)

- Boketo's stake = 49.76% equity interest if converted – single largest investor

- Debtor reincorporated in Delaware and adopted a new certificate of incorporation

- The new certificate provided that the debtor may not "effect any Liquidation Event" unless it has the approval of both "(i) the holders of a majority of the shares of Series A

Preferred Stock then outstanding, voting separately as a class ..., and (ii) the holders of a majority of the shares of Common Stock then outstanding, voting separately as a class."

- Another section of the certificate clarified that any "preparatory steps towards or filing a petition for bankruptcy" falls within the ambit of "Liquidation Event."
- Debtor discovered Advantage was a "lemon"
- Advantage filed for bankruptcy relief, and the debtor followed shortly after
- Debtor filed without requesting consent of its preferred and common shareholders
- Macquarie and Boketo move to dismiss; BK court grants the motion

HOLDING: Fifth Circuit narrows scope of directed appeal; *affirms* dismissal.

- Bankruptcy court certified – and the Fifth Circuit authorized – a direct appeal pursuant to 28 U.S.C. § 158(d)(2)(A). However, the court narrowed the questions presented, declining to opine generally on the legality of "blocking provisions" and "golden shares" on constitutional grounds.
- Fifth Circuit addressed only those very case-specific facts and legal questions – whether Delaware law would permit the parties to amend the corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy filing?
- **And held – there is no compelling federal law rationale for depriving a *bona fide* equity holder of its voting rights just because it is also a creditor of the corporation.**
- However, court found it significant that Boketo was an owner, rather than a creditor.
- Distinguished cases above as presenting creditors' attempts to appoint non-fiduciary officers and directors with the ability to prevent a bankruptcy filing.

Fiduciary Duty Considerations:

- Fifth Circuit noted in *Franchise Svcs.* that under Delaware law, a shareholder is generally free to act in its self-interest, unencumbered by any fiduciary obligation. Only a majority shareholder or a controlling minority shareholder has fiduciary duties.
- As a matter of federal law, fiduciary duties are not required to allow a bona fide shareholder to exercise its right to prevent a voluntary bankruptcy petition. *Id.*
- *But see Lake Mich. Beach*, 547 B.R. at 913 ("The essential playbook for a successful blocking director structure is this: the *director* must be subject to normal *director* fiduciary duties ....")

- "A corporation typically delegates the board of directors authority to manage the business and affairs of the corporation. The authority does not originate with the board of directors but comes to it by corporate delegation, whether by default statutory provisions or corporate governance documents. ***Cases holding that the decision to file for bankruptcy rests with a corporation's board of directors focus on the delegation of authority, not the fact that the directors have fiduciary duties.***" *In re Squire Court Partners Ltd. P'ship*, 574 B.R. at 707.

- Bankruptcy court is not the appropriate venue to seek a remedy for breach of fiduciary duty claims – that would be under state law. *Franchise Svcs.* (citing *Price*)

- Indemnification?! If there are fiduciary duties, and by voting against bankruptcy in favor of the lender but in conflict with fiduciary duty, lender may offer indemnification to its blocking appointee.

2. Restructuring Support Agreements

a. Purpose. A Restructuring Support Agreement ("RSA") represents a bargain between the debtor and other stakeholders to support a particular plan of reorganization that provides signatories assurance that Chapter 11 will modify rights in an agreed upon way in exchange for an agreement to support the plan. RSAs are designed to ensure that a prepackaged plan that the parties develop outside of bankruptcy is implemented inside of bankruptcy or at least serves as an instrument by which key constituencies are bound in order to shape the course of the Chapter 11 case.

b. Advantages. Binding agreements among key stakeholders helps ensure a speedy and more cost-effective reorganization--it can make the Chapter 11 process faster and cheaper. Those that are not parties to the RSA retain all of the substantive rights under the Bankruptcy Code and are free to assert them.

c. Disadvantages. RSAs replace the bargaining environment that the Bankruptcy Code establishes with another one that better suits the interests of parties to the agreement. RSAs have the potential to serve as a tool a dominant creditor uses to exercise control over the debtor, its operations and even the bankruptcy case itself (including distributional outcomes through alteration of substantive rights or "gifts" to those in control of a reorganization).

d. Section 1125. Section 1125 of the Bankruptcy Code on its face limit the ability of parties to enter into binding agreements with each other and prohibits the solicitation of an "acceptance or rejection of a plan" before the court has approved a disclosure statement.

e. Section 1126(e). "On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."

f. Judicial Approval. A number of courts, pointing to fiduciary out clauses, termination events and fact that creditors actually vote only after disclosure statement has been approved, have found that postpetition plan support agreements in which parties commit to support a particular plan are permissible and do not constitute improper solicitations under section 1125. *See, e.g.,In re Indiannapolis Downs, LLC,* 486 B.R. 286 (Bankr. D. Del. 2013): *In re Residential Capital, LLC*, 2013 WL 3286198 (Bankr. S.D.N.Y. 2013*); In re Texaco, Inc.*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988); *In re The Heritage Org., LLC*, 376 B.R. 783 (Bankr. N.D. Tex. 2007). *See generally, Century Glove, Inc. v. First Am Bank of New York*, 860 F.2d 94, 101 (3d Cir. 1988) (opining that the term "solicitation" in section 1125 should be read narrowly).

g. Judicial Rejection. A number of plan support agreements and RSAs have not passed muster under judicial review based upon the circumstances. *See also In re Bush Indus., Inc.*, 315 B.R. 292 (Bankr. W.D.N.Y. 2004)(refusing to enforce RSA that contained contemplated releases for officers and directors); *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010) (refusing to allow debtor to assume prepetition RSA because of failure of disinterestedness under proposed plan that proposed to distribute equity to insider and did not shop the deal or negotiate with other creditors).

h. Fiduciary Out Clauses. The board of directors of a debtor have a fiduciary duty to look out for the interests of the corporation as a whole and maximize value. As such, RSAs cannot compromise the board's duty of loyalty, *see Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), and must contain a "fiduciary out" that releases the debtor from its obligations under the agreement if the obligations imposed are inconsistent with its fiduciary duties. *See In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010) (refusing to allow debtor to assume prepetition RSA because of failure of disinterestedness under proposed plan that proposed to distribute equity to insider and did not shop the deal or negotiate with other creditors).

3. Debtor-in-Possession ("DIP") Financing

a. DIP financing is governed by 11 U.S.C. § 364. Section 364 provides a series of financing terms which commence with ordinary course unsecured debt and, if the DIP can prove that certain credit is unavailable, allows the DIP to offer more and increasing lender protections to obtain financing.

i. A DIP, *without court approval*, may obtain unsecured credit and incur unsecured debt *in the ordinary course of business*. 11 U.S.C. § 364(a). Such unsecured credit is afforded administrative expense priority.

ii. A DIP, *with court approval*, may obtain unsecured credit and incur unsecured debt *outside the ordinary course of business*. 11 U.S.C. § 364(b). Such unsecured credit is afforded administrative expense priority.

iii. If the DIP is unable to obtain unsecured credit, the DIP may, *with court approval*, obtain credit (i) with priority over any or all administrative expenses (a "Superpriority Administrative Expense Claim"); (ii) secured by a lien (a "DIP Lien") on *unencumbered property*; or (iii) a DIP Lien that is *junior* to existing liens of property.

iv. Finally, if the DIP is unable to obtain the secured debt described in (1)(a)(iii), the DIP may, *with court approval*, obtain credit secured by a DIP Lien that is senior or equal a lien already existing on the DIP's property (a "Superpriority DIP Lien")

b. DIP financing is commonly done on an interim and final basis with the maximum amount of funds lend during the interim period.

i. The bankruptcy code protects lenders of interim funds by providing that the reversal or modification on appeal of an order authorizing DIP Financing, including any liens granted thereunder, does not affect the validity of the debt or priority of liens so long as the entity extended credit in *good faith* unless a stay pending appeal was in effect. 11 U.S.C. § 364(e).

ii. Recent Trend: DIPs and DIP lenders take full advantage of section 364(e) by advancing most or a significant portion of the total available funds during the interim period because–if the court authorizes the DIP package–(i) stays pending appeal are typically difficult to obtain; (ii) the debt and liens granted are protected from modification or reversal; (iii) DIP orders commonly including findings of good faith on the party of the DIP lender; (iv) the DIP order commonly locks the case in to the DIP and DIP Lender's schedule preventing other parties from interfering with the case during the exclusivity period and any extensions; and (v) gives the DIP Lender a large superpriority administrative expense claim which provides significant leverage at plan confirmation.

4. Types of DIP Loans and Essential Terms of a DIP Financing Order

a. Types: (i) traditional new money DIP financing; (ii) Rollup DIP financing; and (iii) Creeping Rollup DIP financings

i. New money DIP financing. The most basic form of DIP financing. A DIP Lender agrees to provide new funds to the DIP and funds the full amount upon entry of the DIP Order.

ii. Rollup DIP financing. A prepetition lender provides postpetition financing that effectively pays off (or "rolls up") the prepetition secured debt. A rollup transforms the existing lender's prepetition claim into a postpetition, administrative expense.

iii. Creeping Rollup DIP Financing. A special type of rollup DIP financing. In a creeping rollup DIP, rather than drawing on the DIP Facility to pay down obligations under the prepetition secured credit facility, cash receipts of the DIP received during the course of the case, which would typically be used to fund working capital, are applied to the prepetition secured debt. A common method to accomplish this includes authorizing a DIP Facility and, for every payment received by the DIP Lender from the DIP's operations, extend a like amount of DIP Financing. Like a rollup DIP financing, a creeping DIP financing gradually converts prepetition secured debt into a postpetition, administrative expense. That it happens gradually through the DIP's operations rather than all at once give it the "creeping" characteristic.

b. Essential Terms of a DIP Financing Order

i. Bankruptcy Code Requirements. Procedural findings of fact sufficient to satisfy 11 U.S.C. § 364 and support the entry of the type of DIP financing authorized by the DIP Order.

ii. Budgets and Use of Funds. Specific limitations on the use of funds provided under the DIP Order including rights of the DIP Lender to inspect books and records. The DIP commonly must adhere to a court-approved budget that is subject to certain defined variances. The failure to adhere to the budget within set variances without prior DIP Lender approval commonly is an event of default.

iii. Debtor Acknowledgements. Stipulations from the DIP admitting to the amount of debt, existing and continuing defaults, and secured and priority status. These stipulations bind only the DIP and no other parties in interest.

iv. Type of DIP Financing. The type of DIP financing, i.e., whether it is a new money DIP financing, a rollup DIP financing, or a creeping rollup DIP financing.

v. DIP Liens. The creation and priority of DIP Liens, i.e., liens that secure the repayment of the DIP Financing. These DIP Liens are commonly allowed to prime other existing secured creditors (a "Superpriority DIP Lien").

vi. Administrative Expense Priority. The creation and priority of administrative expense claims. The amount of funds advances to the DIP under the DIP Facility commonly will be treated as a Superpriority Administrative Expense Claim.

vii. Cash Collateral. A DIP Order commonly will address the authorization and use of any existing cash collateral in the DIP's possession as of the commencement of the case and also is subject to a budget with permitted variances.

viii. Adequate Protection. DIP Orders includes a suite of adequate protection provisions to protect the DIP Lender from the diminution of the value of its collateral during the course of the bankruptcy case including: (i) Superpriority Adequate Protection Liens; (ii) Superpriority Adequate Protection Claims; (iii) adequate protection payments or replacement liens; (iv) access to records an reporting regarding operations, cash, and value of collateral; and (v) the reservation of rights to obtain additional adequate protection liens.

ix. Perfection. The DIP Order is the perfecting document and is effective without filing in the proper jurisdiction but, if the lender wishes, may be filed to perfect the liens.

x. Challenge Period. The DIP Order will include a period of time under which any party may challenge the DIP Lender's prepetition liens and debt. The expiration of the challenge deadline bars and future claims against the DIP Lender on the prepetition debt. This deadline is usually extended after the creation of and at the request of the Official Committee of Unsecured Creditors Committee (the "UCC").

xi. Fees for Professionals. With no available unencumbered cash, the DIP will be unable to pay case professionals. The DIP Order usually will include a Professional Fee Carve Out and a Carve Out Cap that will not be subject to the liens and claims created by the DIP Order. The Professional Fee Carve Out will be used to pay US Trustee Fees, the DIP's professionals, and the UCC professionals.

xii. Prohibition use of DIP Proceeds. The DIP Order will prohibit the use of DIP proceeds or cash collateral to fund the litigation of any claims against the prepetition lender that is the DIP Lender to invalidate or modify its liens, the DIP Facility, or the collateral securing the DIP Facility. Commonly thought, funds in a capped amount are allocated to the investigation of the prepetition lenders liens and collateral.

xiii. Surcharge. The DIP Lender will commonly seek to prohibit the surcharge of collateral under 11 U.S.C. § 506(c). This usually is contested in the case by the UCC.

5. Intercreditor Agreements and Bankruptcy Proceedings

a. <u>General</u>. Intercreditor Agreements ("<u>ICA</u>") have many terms and uses but they commonly contain very specific rights and duties between creditors as it relates to a bankruptcy case of the borrower. *See* George H. Singer, *The Lender's Guide to Second-Lien Financing*, 125 BANKING L.J. 199 (2008).

b. <u>Section 510(a) Subordination Agreement</u>. The ICA will contain a statement that the parties agree that it is deemed a subordination agreement within the meaning of 11 U.S.C. § 510(a). Section 510(a) states that subordination agreement are enforceable in bankruptcy to the same extent such agreement is enforceable under applicable nonbankruptcy law.

c. <u>Limitations Relating to DIP Financing</u>. The ICA will commonly have numerous requirements and prohibitions relating to DIP financing including:

   i. Junior secured parties may not object to any DIP financing proposed by the DIP unless the senior secured parties also object to such financing.

   ii. Allowing the senior secured parties to propose DIP financing while prohibiting or conditioning the circumstances under which junior secured parties may propose DIP financing such as proposing DIP financing that does not prime the liens of the senior secured party.

   iii. Junior secured parties may not object to DIP financing including whether the DIP financing is a rollup benefiting the senior secured party.

d. <u>Limitations Relating to 363 Sales</u>. The ICA will commonly prohibit junior secured parties from objection to the disposition of the DIP's assets provided that all liens attach to sale proceeds in the validity, priority, and extent as existed prior to the sale.

e. <u>Waiver of Claims</u>. The ICA will require junior secured parties to waive any and all claims against the senior secured parties relating to any DIP financing and other liens and protections provided by the DIP Order.

f. <u>Adequate Protection</u>. The ICA will provide for the acceptable adequate protection junior secured parties can seek. The ICA will prohibit junior secured parties from seeking or receiving adequate protection from the DIP in a form other than as provided in the ICA. Any adequate protection liens granted will typically be given the priority as described in the ICA.

g. <u>Plan Solicitation and Confirmation</u>. The ICA will prohibit junior secured parties from proposing, supporting, or voting for any plan of reorganization or liquidation of the DIP unless the senior secured party accepts such plan.

h. <u>Relief from the Automatic Stay</u>. The ICA will prohibit junior secured parties from seeking relief from the automatic stay if the senior secured party has not consented or also received relief from the automatic stay.

i. Postpetition Interest and Fees. The ICA will prohibit junior secured parties from objecting to the senior secured party's request for allowance and payment of postpetition interest, fees, or expenses.

j. Objection to Liens or Value. The ICA will prohibit junior secured parties from objecting to the extent of senior secured party liens and value under 11 U.S.C. § 506(a) or the accrual of interest and fees on prepetition debt under 11 U.S.C. § 506(b).

k. Credit Bidding. The ICA commonly will grant the senior secured party the exclusive right to credit bid at a 363 sale.

l. Involuntary Bankruptcy. Junior secured parties are barred by the ICA from seeking an involuntary bankruptcy against the borrower or seeking to appoint a trustee or examiner in bankruptcy.

m. Surcharge. Junior secured parties commonly waive the right to seek surcharge under 11 U.S.C. § 506(c) of the secured party's collateral.

n. Section 1111(b) Election. Junior secured parties are required to waive any right to make an election under 11 U.S.C. § 1111(b).

6. A Case Study: In re Claire's Stores, Case No. 18-10584 (Bankr. D. Del.)

a. Problems and strategies dealing with a junior secured party that aggressively litigates in a bankruptcy case in a manner inconsistent with its rights and obligations under a prepetition intercreditor agreement.

7. Third-Party Releases

a. Current State of Affairs

i. The chapter 11 bankruptcy process culminates with the confirmation of a plan. One of the primary rehabilitative features of the Bankruptcy Code is the chapter 11 discharge received upon confirmation of a plan. There are situations where a debtor attempts to extend releases to certain affiliated non-debtor parties whose participation in or impact on the chapter 11 process will allegedly affect the debtor's ability to reorganize. Non-debtor releases seek to allow non-debtors to reap the benefits of the discharge without undertaking the obligations.

ii. 11 U.S.C. 524(e) provides that the "discharge of a debt of a debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." Facially, section 524 appears to create a specific prohibition on discharging non-debtor liabilities.

iii. 11 U.S.C. 105(a) provides that a bankruptcy court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The equitable powers of the bankruptcy court under section 105(a) present an alternative route that some debtors have taken to justify the apparent prohibition of non-debtor released under section 524.

iv. The Circuit Court of Appeals have split regarding the question of whether a bankruptcy court may confirm a chapter 11 plan of reorganization that includes non-consensual third party releases.

(1) The Fifth, Ninth, and Tenth Circuits have held that the Bankruptcy Code section 524(e) specifically prohibit third party releases. *See, e.g., In re Pacific Lumber Co.,* 584 F.3d 229, 252 (5th Cir. 2009) (holding that the plan could not be confirmed with non-consensual non-debtor releases); *Resorts Intl. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (same); *see also In re W. Real Estate Fund, Inc.*, 922 F.2d 592, 601-02 (10th Cir. 1990) (holding that Bankruptcy Code section 524(e) prohibits a discharge of a non-debtor for liability owed to a creditor).

(2) Courts taking this minority view believe that the specific language of section 524(e) prohibits third party releases and the general equitable powers granted to bankruptcy courts do not permit a bankruptcy court to circumvent such a prohibition.

(3) The Second, Third, Fourth, Sixth, and Eleventh Circuits have held that third party releases may be permissible in certain circumstances. *See In re Am. Hardwoods, Inc.*, 885 F.2d 621, 626 (9th Cir. 1989) ("Section 524(e), therefore, limits the court's equitable power under section 105 to order the discharge of the liabilities of nondebtors . . .."). Courts taking this majority view believe that third party releases are permissible under certain circumstances. Courts adopting the majority view interpret section 524(e) as merely providing that a debtor's discharge in bankruptcy does not affect the liability of third parties. Courts adopting this view also rely on the "broad authority" granted by section 105(a) to "reorder creditor-debtor relations needed to achieve a successful reorganization." *In re Dow Corning Corp*, 280 F.3d 648, 657 (6th Cir. 2002); *see also Matter of Specialty Equip. Cos., Inc.*, 3 F.3d 1043 (7th Cir. 1993) (concluding that the Bankruptcy Code section 524(e) "does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party"). Among other things, "enjoining claims against a non-debtor so as not to defeat reorganization is consistent with the bankruptcy court's primary function." *Dow Corning,* 280 F.3d at 656.

(a) The Majority View is not a broad rule sanctioning all third party releases. Third party releases are to be approved only in "unusual circumstances."

b. Applicable Legal Standard in the Majority View

i. The Sixth Circuit proposed a multi-factor test (the "Dow Factors") and held that if a bankruptcy court found all of the Dow Factors to be present, the bankruptcy court could enjoin a non-consenting creditor's claim against a non-debtor.

ii. The Fourth and Eleventh Circuits have adopted the Dow Factors when determining whether a third party release is permissible, however, each of the Dow Factors is not necessary in every case to grant a third party release.

iii. The Dow Factors:

(1) there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;

iv. the non-debtor has contributed substantial assets to the reorganization;

v. the injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;

vi. the impacted class, or classes, has overwhelmingly voted to accept the plan;

vii. the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;

viii. the plan provides an opportunity for those claimants who choose not to settle to recover in full; and

ix. the bankruptcy court made a record of specific factual findings that support its conclusions.

c. Applicable Legal Standard in the Eighth Circuit

i. *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930 (Barnk. W.D. Mo. 1994)

(1) In *Master Mortgage* the court outlined the following five factors that bankruptcy courts should consider when evaluating the release of claims against a nondebtor third party without the consent or agreement of the party deemed to be bound by such a release:

(a) An identity of interest between the debtor and the third party, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate;

(b) Substantial contribution by the nondebtor of assets to the reorganization;

(c) The essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success;

(d) An agreement by a substantial majority of creditors to support the injunction, specifically if the impacted class or classes "overwhelmingly" vote to accept the plan; and

(e) Provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction.

Let’s Talk: The Local Rules

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Let's Talk: The Local Rules

Chief Judge Kathleen H. Sanberg, Steven C. Opheim, Peter B. Stein

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Let's Talk: The Local Rules

Chief Judge Kathleen H. Sanberg, Steven C. Opheim, Peter B. Stein

Vital to the attainment of substantive relief from the bankruptcy court in a case is compliance with the rules of bankruptcy procedure. In addition to the Federal Rules of Bankruptcy Procedure are the Local Rules of Bankruptcy Procedure. The United States Bankruptcy Court for the District of Minnesota has had a long history of local rules and a bench and bar dedicated to improve the administration of bankruptcy cases and proceedings in the district.

The link to the local rules is at:
http://www.mnb.uscourts.gov/local-rules-complete-full-document

Overview of Bankruptcy Practice Committee

In January 2009, the U.S. Bankruptcy Court for the District of Minnesota appointed a 15-member standing Bankruptcy Practice Committee, a successor to the Local Rules Committee, but with an expanded purpose. The committee's main functions are to recommend needed changes to the Local Rules and to serve as a liaison between the bankruptcy court and the bankruptcy community, providing input and suggestions from the bar and the community at large for improving the administration of bankruptcy cases and proceedings in the District of Minnesota.

Members of the committee represent the full spectrum of bankruptcy and debtor-creditor practices, and serve for two- or three year or permanent terms. Committee members and their contact information are listed on the bankruptcy court's website. Members of the bar and the public are encouraged to contact committee members concerning Local Rule changes and other matters related to improving the operations of the bankruptcy court and clerk's office.

Process for Local Rule or Local Form Amendments

The typical process to amend the local rules or local forms is as follows:

1. An issue is presented to the Bankruptcy Practice Committee by the bench or bar.

2. The issue is reviewed by the consumer subcommittee or commercial subcommittee or both and a proposal is submitted to the full committee.

3. The issue is considered by the full practice committee, which may return the issue to either subcommittee for further work or approve the rule and form amendments.

4. The rule and form amendments approved by the Bankruptcy Practice Committee are referred to the chief bankruptcy judge or judicial liaison.

5. The proposed rule and form amendments are reviewed by the bankruptcy judges. The judges may make changes or request further consideration by the Bankruptcy Practice Committee.

6. The rule and form amendments are posted on the bankruptcy court's website for at least 3 weeks and an e-mail is sent to the bar and others who have requested receipt of the e-mails pertaining to local rules, advising of the proposed amendments and stating the deadline for comments.

7. The bankruptcy judges review comments received. The judges decide the final version of the rule and form amendments.

8. An order is signed by all the judges, promulgating the rule and form amendments with changes in redline shown, and the order is entered.

9. The order is sent to the circuit court executive, along with an explanation of the reason for each proposed change, whether the change was posted for notice and comment, and whether comments were received.

10. The circuit court council on rules reviews the proposed amendments and approves them or "takes no action." In either case, the amendments are effective on the date set forth in the order promulgating the amendments.

11. Approximately one week prior to the effective date of the rule and form amendments, an e-mail is sent to the bar alerting attorneys of the changes.

12. By the effective date of the amendments, the changes are made to the local rules and local forms posted on the court's website.

Local Rules or Forms Recently Amended

The following are some of the changes made to the local bankruptcy rules or local forms in the past couple years:

1. <u>Local Chapter 13 Plan Form</u>.

   On December 1, 2017, the new local Chapter 13 Plan form became effective. The Bankruptcy Practice Committee began to monitor this matter since early 2014, when consideration of a national uniform Chapter 13 Plan was under serious consideration. On April 27, 2017, new Federal Bankruptcy Rule 3015.1 allowed districts to opt out of using the official form and adopt their own local plan form, provided special formatting and disclosure requirements and provisions were implemented. An ad hoc subcommittee of the Bankruptcy Practice Committee first reviewed and analyzed the new official Chapter 13 Plan form and recommended to opt out of the national plan form. The Bankruptcy Practice Committee and the judges agreed to opt out of the national plan form and adopt a local Chapter 13 plan form that contained input from a broad cross-section of constituencies involved.

2. Motions for Summary Judgment.

Local Rule 9006-1 generally provides that moving documents in a case shall be filed and served not later than 14 days prior to the hearing date, with responsive documents filed and served not later than 5 days before the hearing date, and no reply documents to the responsive documents to be served and filed. To improve the consideration of issues in motions for summary judgment, Local Rule 7056-1 was adopted that provides time periods for the service and filing of summary judgment motions. Moving documents for summary judgment shall now be filed not later than 28 days before the hearing date, responsive documents shall be filed and served not later than 14 days before the hearing date, and a reply to any responsive documents shall be filed and served not later than 7 days before the hearing date.

The local rule follows Rule 7056 of the Federal Rules of Bankruptcy Procedure that a motion for summary judgment must be made at least 30 days before the initial date set for an evidentiary hearing, unless a different time is set by local rule or court order.

3. Bankruptcy Transfers of Real Property and the Minnesota "White Pages".

The Minnesota "White Pages" is a supplement to the Minnesota Title Standards and is intended to be a guide to real estate attorneys in documenting real property transfers. In a special collaboration, an ad hoc subcommittee of the Bankruptcy Practice Committee worked with the Title Standards Committee of the Real Property Law Section of the Minnesota State Bar Association to develop revised provisions relating to the transfer of real property that has been the subject of a bankruptcy case. The revised provisions are found in Section I-J of the "White Pages."

4. Valuation of a Secured Claim on a Principal Residence .

The ability to "lien strip" and "cram down" a second (or junior mortgage) on a chapter 13 debtor's principal residence is available in certain situations. Local Rule 3012-1(a) provides the procedure for a chapter 13 debtor seeking to modify a claim that is secured only by a security interest in real property that is the debtor's principal residence. Local Rule 3012-1(b) provides for the procedure for the debtor to obtain a release of the lien after the debtor's completion of payments under the plan. In 2017 the rule was amended to refine the process and clarify the requirements of service on lien holders, documentation requirements of recorded lien instruments, title evidence, and a market value appraisal (for a motion to value claim).

5. Amendments to Voluntary Petition, Lists, Schedules and Statements.

Local Rule 1009-1 provides for the requirements to amend the petition, lists, schedules, and statements. The rule was amended to provide that the "debtor must clearly identify all changes made in any amendments by underlining all additions and lining out all deletions, or by submitting with the amended documents Local Form 1009-1, containing a complete list of all changes reflected on the amended documents when compared with the original or the most recent amendments." There are requirements to amend other schedules, including the filing of the Summary of Assets and Liabilities form with some amendments. The rule makes changes to various bankruptcy documents filed by a debtor more transparent.

Local Rules Not Amended

Not all issues presented to the Bankruptcy Practice Committee are appropriate for action. Issues not appropriate include those involving ethical issues, substantive law, or issues still emerging in practice. The following are examples of these situations:

1. Scope of undertaking of an attorney for debtors in a chapter 7 or chapter 13 case.

An attorney contacted the Bankruptcy Practice Committee regarding the scope of legal services to be rendered by the attorney. The issue concerned an attorney's non-representation of a debtor in a post-petition matter. The Bankruptcy Practice Committee replied that it does not serve in a policing capacity of attorneys, but exists particularly to review, maintain, and recommend changes to the local rules.

2. Chapter 12 or 13 Debtor's certifications prior to receiving a bankruptcy discharge.

Section 1328(a) of the Bankruptcy Code provides for the debtor to receive a discharge "after completion by the debtor of all payments under the plan" and Local Rule 4004-1(a) provides for the entry of a discharge order after the plan payments are completed. The local rule also requires the debtor in a chapter 12 or 13 case to file Local Form 4004-1 that contains a certification whether the debtor has paid all required domestic support obligations. An attorney contacted the Bankruptcy Practice Committee whether the local form should be amended to include a provision whether the debtor has made all direct payments to creditors (beyond those payments made by the debtor to the chapter 13 trustee). The issue presented is whether direct payments by a debtor to a creditor constitute "payments under the plan" and whether the failure to make such direct payments is a basis to deny the debtor a bankruptcy discharge. Courts are split on this issue. The Bankruptcy Practice Committee declined to change the local form as the matter concerns substantive legal issues beyond the role of the Bankruptcy Practice Committee.

3. Chapter 13 consumer debtor's request to incur credit post-confirmation.

Chapter 13 consumer debtors may seek credit for the purchase or refinance of a home or a car. A prospective lender may request a "loan approval letter" from the trustee (which the chapter 13 trustee's office may not provide) or a court order. Sections 1304 and 364 of the Bankruptcy Code, working together, authorize a debtor engaged in business to incur credit. Sections 1304 and 364 do not specifically provide for the authority of debtors not engaged in business to incur credit or debt. Other courts have adopted local rules to provide a process by motion or application for a consumer debtor to obtain an order to incur credit. The Bankruptcy Practice Committee reviewed this issue and declined to propose an amendment to the local rules as outside the express provisions of the Bankruptcy Code.

4. State law procedure for discharge of judgments on real property.

Minnesota Statutes, Section 548.181 provides the process for a judgment debtor who has received a discharge under the bankruptcy code to apply for a discharge of a judgment. The clerk's office of the bankruptcy court periodically receives inquiries from debtors on how to deal with judgments previously entered against them when they seek to sell their home. The issue was submitted to the Bankruptcy Practice Committee whether to include in the local forms for Notice of Responsibilities of Chapter 7 (or 13) Debtors and Their Attorneys to require attorneys to notify debtors of the procedure under Minnesota law to deal with this issue. The Bankruptcy Practice Committee declined to impose a requirement of notification of a state law process as beyond the scope of the attorney's required responsibilities for representation of debtors in a (federal) bankruptcy case. The issue was viewed more properly as a matter of best practices for attorneys.

5. Electronic signature of bankruptcy documents by debtors.

Local Rule 9011-4 generally provides that all documents presented for filing shall be signed. An attorney raised the issue to the Bankruptcy Practice Committee whether to amend our local rule to provide electronic signatures by debtors on bankruptcy documents filed with the bankruptcy court. The Bankruptcy Practice Committee noted the existence of electronic signature programs such as Authentisign™ that are used for real estate documents. However, there are significant issues to be considered, beyond convenience and efficiency, that warrant further investigation and development. As such, the Bankruptcy Practice Committee will follow this developing area and review how other courts adopt protocols for debtor's electronic signatures before proposing any rule changes.

√ Tips for the Practitioner

1. The granting of substantive relief begins with compliance with procedural rules.

2. Consider in any matter before the bankruptcy court not only the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, but also any applicable local bankruptcy rule.

3. The numbering for the local rules corresponds with the federal rules. For example, on the issue of time periods for service and filing of documents, review both Federal Rule 9006 and Local Rule 9006-1.

4. The numbering for local forms follows the numbering of the local rules. For example, Local Form 9013-2 on a Notice of Hearing and Motion corresponds to Local Rule 9013-2.

5. Cite to both the applicable federal and local rules involved in the motion documents. See Paragraph 5 of Local Form 9013-2.

6. Contact a member of the Bankruptcy Practice Committee if you have an issue that the committee should consider for better administration of bankruptcy cases and proceedings. The current members of the Bankruptcy Practice Committee are posted on the bankruptcy court's website.

Bankruptcy Litigation Financing: Creating Something out of (Almost) Nothing

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Bankruptcy Litigation Financing:
Creating Something Out of (Almost) Nothing

Schuyler G. Carroll, Robert Minkoff & Amy J. Swedberg

I. Fundamentals of Litigation Financing

- Mutually Beneficial Product: Litigation Financing is a growing area of finance that has the potential to accrue value to both sides of the transaction: Plaintiff/ Law Firm, and Funder

- Plaintiff obtains financing to unlock value of litigation that would not be otherwise pursued because of costs

- Lender receives an attractive return on their investment in a low-yielding opportunity climate

- Funder can be a third-party unrelated to the subject matter of the lawsuit or it can be a related party, such as an original plaintiff financing an action that was initiated prior to a bankruptcy filing that decides to fund a trustee who succeeds as the plaintiff in that action

- Generally non-recourse so if the litigation is unsuccessful, the plaintiff owes the financer nothing

II. Who May seek Litigation Financing

- Debtors in Possession
- Bankruptcy Trustees
- Liquidating Trustees
- Creditors' Committees
- Receivers / Assignees
- Plaintiffs law firm

III. Typical Expense Scenarios: Terms of the operational expenses of the case are typically set as part of the funding agreement

A. Partial-Contingency

- Reduced hourly billing rates (70-80%)
- Splitting a contingency (estate, attorney and litigation funder)

B. Expenses: funder funds the expenses in full or partially

C. Other creative applications

IV. Common Issues

- Settlement Authority: the claimholder usually retains settlement control subject to some limitations stated in the funding agreement

- Diligence Process: a funder should conduct due diligence as expeditiously as possible, securing funding is often a time sensitive endeavor (e.g. bankruptcy trustees must commence litigation on chapter 5 causes of action within the later of 1 year after appointment or 2 years after the petition date)

- Commitment to Fund: a funding agreement should not allow the funder the discretion to prematurely exit an investment based upon any re-evaluation of the merits of the litigation

- Attorney Independence and Confidentiality: a funder should not interfere with the independent professional judgment and duty of undivided loyalty of the attorneys representing the plaintiff/trustee, and the parties should have in place sufficient confidentiality/NDA or common interest privilege agreements

V. Criticisms

- Promotes frivolous litigation? Financers own self-interest in making a good investment should detract from frivolous litigation

- Confidentiality and Attorney/Client Privilege: disclosures in retention agreements; litigation financing could undermine the fiduciary and ethical obligations of a lawyer to his/her client

- Conflicts of interest: most litigation finance transactions do not involve the transfer of control of the litigation to the financer; funding agreement should be clear that the financer has no rights to dictate settlements or otherwise interfere with the litigation

VI. Application of Litigation Financing to Bankruptcy Marketplace

A. Extracting Value from Barren Cases

- Otherwise asset-less cases with valuable litigation
- Litigation financing can create a bankroll for pursuing these cases
- Interests between funder and bankruptcy professionals must be properly aligned

B. Cutting the Ugly Check

- Professionals reluctant to bear the burden of hard expenses such as discovery costs, expert witnesses
- Realistic budget review
-

CASE STUDIES

Oak Rock

E.D.N.Y. Case No. 13-72251

Mutually Attractive Profile	• Smoking-gun Ponzi case • Estate faced tough decision of paying hard costs
Proposed Split	• In exchange for one-time funding, Cedar Glade would have received 50% of the litigation award capped at 2X or 3X depending on timing of the litigation
Lessons Learned	• Challenge of proposing financing to Court • Section 363(b)(1) of the Bankruptcy Code

Chapter 7 Individual Debtor (A)

- No asset case BUT FOR pending fraudulent transfer litigation against spouse, spouse's company and son-in-law that original Plaintiffs litigated for 2 years prior to bankruptcy

- Original Plaintiffs' counsel willing to continue funding prosecution of fraud transfer case in the name of Trustee

- Trustee settles claims against son-in-law for $200,000; funds may be subject to Plaintiff's pre-petition charging liens and Plaintiffs' counsel has incurred in excess of $100,000 prosecuting the case in bankruptcy including *ex parte* search of Debtor's home

- Original Plaintiffs and Trustee agree to settlement where trustee retains $100,000 for the bankruptcy estate and the original Plaintiffs receive $100,000 and assignment of Trustee's remaining claims against spouse and spouse's company in exchange for waiving all claims against estate including post-petition fees of Plaintiffs' counsel

- Original Plaintiffs pursue remaining claims after successfully defending motion to dismiss on the basis the Trustee could not assign a state law fraud transfer claim; Judge Nelson held the state law claims were property of the estate that could be assigned

<u>Chapter 7 Individual Debtor (B)</u>

- No asset case BUT FOR valuable whistle blower litigation
- Debtor seeks to have trustee abandon the litigation
- Cedar Glade agrees to pay claims in full (with a cap)

<u>Chapter 7 Corporate Debtor (A)</u>

- No asset case BUT FOR breach of fiduciary duty litigation
- Secured creditor asks trustee to pursue litigation
- Trustee has no assets or funding to pursue litigation
- Secured creditor agrees to fund litigation in exchange for split of net recoveries (after attorney fees and expenses)
- Settlement reached, which provides substantial recoveries to secured creditor and to trustee, after payment of attorney fees and expenses

<u>Magnesium Corp.</u>
S.D.N.Y. Case No. 01-14312

Award Granted:	After 16 years, Chapter 7 trustee chalks up a win at trial court ($213MM award)
Financing Offer:	Litigation funder proposes buying the claim and sharing ups if trustee successful on appeal
Then . . .	Shocker: Debtor counters! Bidding war
Result:	Original funder declared winning bidder

Chapter 7 Corporate Debtor (B)

- No asset case BUT FOR insurance litigation
- Counsel agrees to commence case on contingency, but unwilling to prosecute case through trial
- Counsel enters into agreement with litigation funder - counsel receives estimated amount of budget through trial
- Litigation funder receives 1.4x the amount paid, plus 50 percent of all remaining recovery

TransTexas Gas Corp.
Bankr. S.D. Tex. Case No. 02-21926

- Ch. 11 plan created Liquidating Trust to pursue claims held by estate including claims against the debtor’s former directors and officers (D&O Claims)
- Liquidating Trust’s beneficiaries were former noteholders and the indenture trustee was appointed the Trustee of the Liquidating Trust; the Trust’s actions were controlled by a Steering Committee under the terms of a Trust Agreement
- Carl Icahn entity loaned the Liquidating Trust $300,000 under a Promissory Note with 15% interest, compounded annually
- Unfortunately, litigation did not yield funds sufficient to make distributions to the Liquidating Trust beneficiaries above the amounts owing under the Note; D&O Claims were dismissed and minor settlement after Liquidating Trust filed an appeal

Chapter 7 Corporate Debtor (C)

- No asset case BUT FOR breach of fiduciary duty litigation
- Trustee unwilling to prosecute case
- Creditor agrees to purchase litigation for $25,000. In exchange creditor receives first recovery, up to amount of attorney fees and expenses, plus $25,000. Remainder of recovery paid into estate for distribution to creditors
- Defendant (also a creditor) objects and offers to purchase for higher amount
- Auction ensues
- Creditor successful bidder for $175,000

Breaking Free from the Payday Loan Debt Trap and Credit Building Do’s and Don’ts

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Exodus Lending
Minneapolis

Liz Peter
Leader One Financial Corp
Minneapolis

Exodus Lending

Exodus Lending is a nonprofit dedicated to helping Minnesotans get out of payday loan debt. Our mission is to provide trapped borrowers a just pathway toward financial stability. To achieve this goal, Exodus Lending pays off payday loans up to $1,000 for program participants and sets up a plan with them to repay only the amount refinanced, with no interest or fees, over the course of 12 months.

Enrollment

STEP 01

Awareness

Individuals often hear about our program through a referral from one of our community partners, an Internet search, in a news article, or from family and friends.

How can I refer someone to Exodus Lending?

To refer someone to our program, visit our website at exoduslending.org/get-help/referral/.

STEP 02

Contact Us to Learn More

Individuals interested in our program can learn more by visiting our website at exoduslending.org or by contacting our program coordinator directly by phone at 612-615-0067 ext. 701 or email at info@exoduslending.org.

In a conversation with Exodus Lending's program coordinator, individuals will learn if they are eligible for our program.

Am I eligible?

To be eligible, you must answer YES to ALL of the following:

- I live in Minnesota
- I have payday loan debt
- I've had payday loan debt for more than 30 days I
- have an individual loan for $1000 or less
- I have a steady income*

*This can be earned at a job or consistent unearned income, such as social security, pension, etc.

STEP 03

Make an Appointment

Exodus Lending enrolls participants at our office at 2805 E Lake St, Ste 102, in Minneapolis. We can enroll participants living outside the Twin Cities metro area over the phone, via fax, or by mail. We offer weekday, evening, and Saturday morning appointments. To make an appointment, contact our program coordinator (see above).

We do not do any walk-in enrollments.
To prepare for the appointment, individuals should gather all of the required documents.

What should I bring to my appointment?

You are expected to bring the following to their scheduled appointment:

- Voided check
- Photo ID
- Loan documents for the loan(s) to be refinanced
- Pay stubs or proof of income for the past month

We cannot enroll you in the program unless you bring all the above documents to your appointment.

STEP 04

Program Intake

The program coordinator will walk through the following paperwork with the individual:

- Loan application
- Program agreement
- Promissory note
- ACH form
- Release of information form, if necessary
- Survey

Note: Exodus Lending is required to perform an OFAC check.

What is ACH and how does it work?

An ACH payment is an electronic payment that is created when an individual gives authorization for an entity to debit directly from his/her checking or savings account for the purpose of paying a bill.

What is OFAC and what is being checked?

The Office of Foreign Assets Control (OFAC) is part of the U.S. Treasury Department. They require us to check to ensure that potential participants are not on the "specially designated nationals and blocked persons list." Exodus Lending will not ask for your citizenship status.

STEP 05

Payday Loan Payoff

Exodus Lending pays off the loan directly to the payday lender(s). We do not issue loans directly to individuals.

Does Exodus Lending give out loans?

We do not give out loans. We only refinance payday loans. However, we do not encourage individuals to take out a payday loan in order to work with us. Instead, we direct them to different community resources.

Program

STEP
06

First Payment

Exodus Lending encourages program participants to make their first payment to Exodus Lending no sooner than 15 days and no more than 45 days after enrollment. Payments are taken via ACH direct withdrawal.

The interest rate on Exodus Lending loans is 0%.

What are the fees on the loan payments?

There are no fees associated with the Exodus Lending program, except for any returned payment fees. If the bank charges Exodus Lending, we pass along that fee to the program participant.

STEP
07

Monthly Payments

Participants are contacted more often if they miss a payment or request information. Participants are welcome to contact the program coordinator at their will as well. Program participants and Exodus Lending program coordinator interact via phone, in person, by text or email.

What if I cannot make a payment?

If you cannot make a payment, you must contact the program coordinator at least three business days in advance of your scheduled payment date.

As a participant, you are expected to stay in contact with the program coordinator throughout the program.

STEP
08

Savings Incentives

Exodus Lending offers incentives for participants who meet with a financial adviser and contribute to a personal savings account. Participants can receive up to $250.

Participants must pay their loans in full and notify the program coordinator of incentives earned within 60 days of the end of the program agreement to receive the incentives.

How do I qualify for the incentives?

For every financial counseling session (up to three) you attend, Exodus Lending will give you $50 (up to a maximum of $150) via direct deposit to your bank account.

For every $100 you save over the course of the program, Exodus Lending will provide you $25 (up to a maximum of $100 in savings incentives) via direct deposit to your savings account.

STEP
09

Final Payment

Participants graduate from the program when they have finished paying their loan and completed our follow-up survey.

Once a participant's final payment is received, Exodus Lending will initiate the ACH transfer of any earned incentive payments to the participant's savings account by the end of the following month.

How will I know when I finish?

You will receive a payoff statement when your loan is paid off in full. You will also receive an email from Exodus Lending to complete our follow-up survey.

STEP
10

Stay Involved

While Exodus Lending is designed to be a one-time program, we encourage graduates to stay connected with us after completion by staying on our mailing list, and connecting with us on social media. (@ExodusLending on select platforms).

How can I support Exodus Lending?

We strongly urge you to share your story with your friends and family - discourage them from taking out a payday loan themselves and encourage them to come to Exodus Lending if they need help.

If you would like to donate to Exodus Lending, please visit exoduslending.org/support-us/donate/.

Exodus Lending is the only nonprofit dedicated solely to helping Minnesotans break free from payday debt.

What is a payday loan?

Payday loans are small-dollar loans with interest rates as high as 450%. Unlike a typical loan, payday lenders require the borrower to pay off the loan in full on their next payday. Payday lenders require direct access to the borrower's bank account and make these loans without fully investigating the borrower's ability to repay.

What is the payday loan debt trap?

Borrowers unable to pay off the loan by their next payday often re-borrow, leading to "the payday loan debt trap." Every two weeks, trapped borrowers pay only the interest and fees to "renew," without ever being able to pay off the principal loan amount.

How does the payday loan debt trap impact Minnesotans?

In 2017, nearly 49,000 Minnesotans took out more than 330,000 payday loans. Borrowers averaged 8 loans each, with 58% of borrowers taking out at least 5 loans and 10% taking out over 20 loans.

Minnesotans for Fair Lending estimates that between 1999 and 2014, more than $110 million in interest and fees was drained from our communities. Minnesota payday loan borrowers paid nearly $10 million in interest and fees in 2017 alone. That is a large amount of money that is not being used for groceries, rent/mortgage payments, transportation, childcare, and other needed expenses, leading to an increase in financial distress for families, which can have devastating physical, emotional and psychological consequences over time.

How does Exodus Lending respond?

Exodus Lending pays off these predatory payday loans. Program participants pay us back through manageable monthly payments over twelve months, with no interest and no fees.

Participants are Minnesota residents with a steady income who have found themselves caught in the payday loan debt trap. Our tested program offers referrals to financial counseling, incentives for savings and support for personal money management.

Since we began in 2015*...

- ★ **98** loan participants have repaid in full
- ★ **94** current loan program participants
- ★ **$867** average refinanced per participant
- ★ **$149,945** total refinanced
- ★ **$450,653** total saved for participants

Our current loan program participants*...

- ★ **47%** are people of color
- ★ **68%** are women
- ★ **73%** live in the Twin Cities 7-County Metropolitan Area
- ★ **32%** live in Minneapolis or St. Paul

- ★ **301%** average payday loan APR
- ★ **>90%** repayment rate
- ★ Average age is **47** years old
- ★ Median income is **$33,512**

*as of 09/12/2018

What does our program mean for participants?

"I appreciate everything you do for me and my family and I think back to a year ago and where I am right now, I don't think I would be there if it wasn't for Exodus. I was literally able to pull myself back up. I think all my loans came to like $978. That's the check that Exodus gave and that was to pay off - but every month I was paying close to $400 in interest on that.

So I sit and think, what does Exodus mean to me? It means $450 times twelve. Because that's how much money I saved a year. And with that money, I moved. My partner got a new car. We caught up on our bills. We were able to save some money and our family and friends were able to put together, a semi-reception kind of thing on the 23rd of July for us on our anniversary this year. But we were able to save for that and contribute. We didn't have to take out credit, so that is the value of Exodus for me. I think of it over time, all the money- like everything I did with the money and that's what Exodus did. I don't think I would have been able to pull that off if it wasn't for you guys, so, thank you. I really, really appreciate it."

- Margretta, program participant

How can you help?

- ★ **Donate!** Our program exists because of the generous financial support of caring Minnesotans. You can donate any amount on our website or send a check to Exodus Lending.
- ★ **Spread the word!** Share the work of our organization with friends, family, and colleagues. Let people who may need our help know we are an available resource.
- ★ **Contact your legislators!** Stay informed about payday lending and let your representatives know your opposition to predatory payday loans in our community.

Exodus Lending is a Minnesota nonprofit organization; it is tax-exempt under Internal Revenue Code section 501(c)(3).

For More Information: Contact Sara Nelson-Pallmeyer, Executive Director
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LENDING

Farm Bankruptcies: Comparing and Contrasting the Options – Chapter 12 vs. Chapter 11 vs. Chapter 13

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An excerpt from:

Minnesota CLE's: **Bankruptcy Practice in Minnesota Deskbook**

Chapter Twenty

Chapter 12 – Family Farmer with Regular Income

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§ 20.1 INTRODUCTION

A. Overview

Chapter 12 of the Bankruptcy Code was enacted in 1986 to meet the needs of family farmers faced with increasing mortgage interest rates, high production costs, falling land values, and falling commodity prices during the agricultural crisis of the 1980s. H.R. Rep. No. 99-958, 99th Cong., 2d Sess., at 45, 48 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5246, 5249; Neil E. Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 U. Kan. L. Rev. 425 (1986); *Travelers Ins. Co. v. Bullington*, 878 F.2d 354, 360 (11th Cir. 1989). The principal purpose of the legislation was to give family farmers facing bankruptcy a chance to reorganize their debts and keep their farms. *Wiese v. Cmty. Bank of Cent. Wis.*, 552 F.3d 584, 586 (7th Cir. 2009); H.R. Rep. No. 99-958. Though similar in form to chapter 13, chapter 12 provides notable additional benefits to eligible farmers, including simplified filing, higher debt ceilings, secured debt cramdown/lien-stripping, favorable capital gains tax treatment, retention of property necessary for reorganization, and operation as a debtor in possession.

COMMENT

Chapter 12 eligibility was extended to family fisherman in 2005. Analysis of chapter 12 as it relates to family fisherman is intentionally disregarded for this publication in order to focus on family-farmer chapter 12 bankruptcy practice.

Chapter 12's limited eligible demographic equates to limited case law addressing and interpreting statutes. Chapter 13 cases can be highly persuasive in the absence of relevant chapter 12 authority, due to the similarities between the chapters. *See In re Plata*, 958 F.2d 918, 921 n.9 (9th Cir. 1991).

B. Eligibility

1. Burden

The burden of establishing eligibility in chapter 12 lies with the party filing the bankruptcy petition. *In re Tim Wargo & Sons, Inc.*, 869 F.2d 1128, 1130 (8th Cir. 1989) (citing *In re Rott*, 73 B.R. 366, 371 (Bankr. D. N.D. 1987)). Because involuntary petitions are not permitted in chapter 12, the burden will always be on the debtor to prove eligibility. 11 U.S.C. § 303(a) ("An involuntary case may be commenced only under chapter 7 or 11 of this title…."); *see also In re Frusher*, 124 B.R. 331 (D. Kan. 1991).

COMMENT

Creditors and parties in interest cannot circumvent the prohibition on involuntary chapter 12 petitions by use of the conversion power. Each remedial chapter contains provisions protecting against involuntary conversion to chapter 12. 11 U.S.C. §§ 706(c); 1112(d); 1307(d).

2. Farming Operation Requirement

A debtor must be engaged in or conducting a farming operation to be eligible for chapter 12. *See* 11 U.S.C. §§ 109(f); 101(18). Under the Bankruptcy Code, the term "farming operation" includes "farming, tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products in an unmanufactured state." 11 U.S.C. § 101(21). This list is not exclusive, however, and other activities not specifically mentioned may also qualify as farming operations. *In re Watford*, 898 F.2d 1525 (11th Cir. 1990). Courts decide whether an activity qualifies as a farming operation on each case's unique set of facts. *See In re Buckingham*, 197 B.R. 97 (Bankr. D. Mont. 1996). Courts generally construe the definition liberally, but not so broadly as to bring in operations clearly outside the nature of practices one normally associates with farming. *See In re Dakota Lay'd Eggs*, 57 B.R. 648, 653 (Bankr. D. N.D. 1986).

As the court in *In re Teolis*, 419 B.R. 151 (Bankr. D. R.I. 2009) stated:

> [T]wo main methods have evolved in determining whether a particular enterprise constitutes a farming operation. One view concentrates on whether the operation is subject to "traditional risks of farming," … while the other employs a "totality of the circumstances" test, of which risks of farming is but one factor to be considered.

Teolis, 419 B.R. at 162 (citations omitted). It appears that courts are turning away from the "traditional risks" test towards an analysis of the totality of the circumstances. *See id*.; *Watford*, 898 F.2d 1525; *In re Hettinger*, 95 B.R. 110 (Bankr. E.D. Mo. 1989); *In re Coulston*, 98 B.R. 280 (Bankr. E.D. Mich. 1989); *Matter of Burke*, 81 B.R. 971, 976 (Bankr. S.D. Iowa 1987); *In re Mikkelsen Farms, Inc.*, 74 B.R. 280, 284–85 (Bankr. D. Or. 1987). Under the totality of the circumstances, a number of non-exclusive factors are considered, including:

- the location of the operation;
- the nature of the enterprise;
- "the type of product and its eventual market";
- "the physical presence or absence of family members" at the property;
- "ownership of traditional farm assets";
- whether the owners are engaged in the process of "growing or developing crops or livestock"; and
- whether the operation is "subject to the inherent risks of farming."

See In re Osborne, 323 B.R. 489, 494 (Bankr. D. Or. 2005). The Eighth Circuit declined to adopt either test, however, instead directing that "'farming' is to be understood in its ordinary usage," and that there be "some indicia of involvement on the part of the debtor in the farming activity which generates the income he seeks to have credited toward satisfaction of the ["family farmer" requirements]." *See In re Easton*, 883 F.2d 630, 633–35 (8th Cir. 1989).

PRACTICE TIP

The "totality of the circumstances" test is nearly synonymous with the Eighth Circuit's common-sense approach. The non-inclusive factors generally used in the totality of the circumstances are useful indicators to be used when attempting to convince a bankruptcy court judge that a novel or non-traditional activity is a farming operation.

Some general trends have emerged from case law addressing the farming operation requirement. Those trends are:

- Rental income, without any involvement in farming operation by the debtor, is income not derived from a debtor's farming operation. *Id.*; *see also Matter of Armstrong*, 812 F.2d 1024, 1026 (7th Cir. 1987) (income generated from farmland rented to another party is not income received from a farming operation); *In re Tim Wargo & Sons, Inc.*, 869 F.2d 1128 (8th Cir. 1989) (a corporate landlord debtor did not qualify for chapter 12 relief because the farming operation was conducted solely by a tenant farmer); *In re Buckingham*, 197 B.R. 97, 106 (Bankr. D. Mont. 1996) (income from rental of grazing land was not derived from a farming operation).

- Income from the sale of farm-related products, including fertilizer, seed, and other farm byproducts not produced through the activities of the debtor, is not derived from a farm operation. *In re Richardson*, 113 B.R. 28, 29 (Bankr. D. Colo. 1990) (explaining, in dicta, that a merchant who sells a farmer seed and fertilizer does not derive that income from a "farming operation" as defined under the Bankruptcy Code); *In re Dakota Lay'd Eggs*, 57 B.R. 648, 653 (Bankr. D. N.D. 1986) (income obtained through the purchase and resale of chicken eggs was not income derived from a farm operation).

- Income from the sale of farm assets may be derived from a farm operation. *See Armstrong*, 812 F.2d 1024 (income from a debtor's sale of farm machinery was farm income where the machinery was "inescapably interwoven with his farming operation" and the debtor "was never in the business of buying, selling, or trading such machinery."); *In re Van Fossan*, 82 B.R. 77, 78–81 (Bankr. W.D. Ark. 1987) (income from the sale of land which debtor admitted was held only for speculative purposes was not farm income).

- Providing services for farm producers, although farm-related, produces income that is derived indirectly from the farming operation of another, and is not itself a farming operation. *See In re McNeal*, 848 F.2d 170 (11th Cir. 1988) (holding that a chicken coop cleaning and fertilizer business did not constitute a farming operation); *Dakota Lay'd Eggs*, 57 B.R. at 653 (income from the transport of products and the sale of feed that is not the result of any form of planting or husbandry of the debtor was not derived from a farming operation); *Buckingham*, 197 B.R. at 106 (horse-breaking service was provided in connection with another's farming operation and did not arise from the farm operation of the debtors); *In re Van Air Flying Serv., Inc.*, 146 B.R. 816 (Bankr. E.D. Ark. 1992) (debtors' aerial fertilizer, herbicide, insecticide, and fungicide application business was not a farming operation).

- The guarantee of debt, including a real property debt, without more, is not enough to establish a farming operation. *In re Easton*, 883 F.2d 630, 636 (8th Cir. 1989) ("Land or an interest in land, without more, is plainly not a farming operation….").

- Cultivation of trees, shrubs, flowering plants, or vegetable plants is most likely a farming operation. *See In re Teolis*, 419 B.R. 151, 162 (Bankr. D. R.I. 2009) (concluding that trees, shrubs, and flowering and vegetable plants grown by the debtors in their various stages of maturity were crops, and thus debtors were conducting a farming operation).

Given the dynamic nature of modern farming enterprises, a debtor might be involved in activities that constitute both farming and non-farming operations. In such circumstances, a court will make the distinction between the farming and non-farming operations of the debtor. For example, in *Dakota Lay'd Eggs*, the bankruptcy court of North Dakota determined that the following income sources were derived from a farming operation: (1) income from eggs produced from chicken flocks owned and maintained by the debtor; and (2) income from eggs produced from chicken flocks owned by the debtor but managed by nondebtor farmers who provided all necessary production facilities and items necessary to maintain the chickens, except feed and medication. The court determined that the following income sources were not derived from a farming operation: (1) income from eggs obtained through contracts with independent farmer/producers who owned the hens; (2) income from eggs obtained on the open market and resold; (3) income derived from the sale of feed; and (4) income from trucking. In *Easton*, the Eighth Circuit noted that its approach to measuring income followed that of the bankruptcy court in *Dakota Lay'd Eggs*.

PRACTICE TIP

Attorneys grappling with this issue should itemize the debtor's activities and attempt to determine whether the process directly involves the process of cultivating crops or producing livestock, or is an indirect product or service used to assist farmers in that production.

Such an analysis is necessary, as the debtor must also meet income, debt, and asset requirements, which are discussed in the next subsection.

3. Family Farmer Requirement

A debtor must be a "family farmer" as defined in the Bankruptcy Code. 11 U.S.C. § 109(f). A family farmer can be an individual, an individual and spouse, a corporation, or a partnership. 11 U.S.C. § 101(18).

A debtor that is an individual or an individual and spouse is a "family farmer" if the following four conditions are met:

1. The individual or individual and spouse are engaged in a farming operation.

2. Aggregate debts do not exceed $4,153,150 on the date of filing. This debt limit is adjusted based on the consumer price index.

3. Not less than 50 percent of the aggregate noncontingent, liquidated debts arise out of the individual or individual and spouse's farming operation on the date of filing. Debts for the principal

residence of such individual or such individual and spouse are excluded from this calculation, unless the debt arises out of a farming operation.

4. More than 50 percent of the individual's or individual and spouse's gross income are received from the farming operation. This calculation may be based on the taxable year preceding the year of filing, or each of the second and third taxable years preceding the year of filing.

11 U.S.C. § 101(18)(A).

a. Defining Gross Income

Declarations made on income tax returns regarding "farm income" are not determinative of whether the income is income from a farming operation. *See*, *e.g.*, *In re Burke*, 81 B.R. 971, 977 (Bankr. S.D. Iowa 1987). As discussed *supra* in section 20.1.B.2, the issue of whether income arises from a farming operation requires analysis of each income producing activity and case law trends on the subject.

Principles of tax law may be helpful, however, in analyzing issues relating to the term "gross income" as used in section 101(18). Most importantly, inventory costs, including livestock purchases, are not included in gross income for tax or bankruptcy purposes. As stated by the Bankruptcy Court for the District of Montana, "[t]he definition of gross income in [I.R.C. § 61] includes 'gross income derived from business.' As to a business, however, gross income is usually the same as gross profit, not gross receipts. Gross profit is the total receipts from sales minus the cost of goods sold." *In re Pratt*, 78 B.R. 277, 280 (Bankr. D. Mont. 1987). As further stated by the *Pratt* court and specifically applicable to livestock purchases:

> A farmer on the cash basis must include in gross income all cash, or the value of merchandise or other property received from the sale of livestock and produce which he has raised, profits from the sale of livestock or other items which have been bought by him, and gross income received from all other sources…. Profit from the sale of livestock or other items bought by a farmer is computed by deducting the cost from the sales price.

Id. This same analysis was applied in *In re Gosset*, 86 B.R. 941 (Bankr. S.D. Ohio 1988), and is reflected in official tax schedule F (Profit or Loss from Farming), available on the IRS website at <www.irs.gov/pub/irs-pdf/f1040sf.pdf>. That form explicitly calls for the deduction of the cost of livestock purchases before calculating gross income of the farming operation.

PRACTICE TIP

The calculation of income attributable to a farming operation requires more than a reliance on tax returns. It involves a careful analysis of the income producing activities the debtor is involved in, as discussed *supra* in section 20.1.B.2, to determine whether the income is derived from a farming operation.

b. Defining "Engaged In"

Even if a debtor can show that past or present activities constitute a farming operation, a debtor that is an individual, or an individual and a spouse, must still satisfy the requirement of being "engaged in" those activities. *See* 11 U.S.C. § 101(18)(A).

11 U.S.C. § 101(18)(A) explicitly states that the term "family farmer" means an individual or individual and spouse "engaged in a farming operation." As numerous courts have noted, the inclusion of the phrase "engaged in a farming operation" was not merely superfluous and that satisfying the income and debt requirements of 11 U.S.C. § 101(18)(A) is not sufficient. *See In re Nelson*, 291 B.R. 861, 869 (Bankr. D. Idaho 2003) ("[T]he phrase 'engaged in a farming operation' in § 101(18) requires an examination of more than the debtor's tax returns for the taxable year preceding the year of a debtor's filing."); *see also In re Clark*, 288 B.R. 237 (Bankr. D. Kan. 2003); *In re Lockard*, 234 B.R. 484 (Bankr. W.D. Mo. 1999); *In re Buckingham*, 197 B.R. 97 (Bankr. D. Mont. 1996); *In re Indreland*, 77 B.R. 268 (Bankr. D. Mont. 1987); *In re Tart*, 73 B.R. 78 (Bankr. E.D.N.C. 1987). As stated by the bankruptcy court for the Eastern District of North Carolina:

> Section 101(17) [present section 101(18)] states that a "family farmer" means an individual "engaged in a farming operation"; no such language is found in the Section 101(19) [present section 101(20)] definition of "farmer". The inclusion of this language in § 101(17) suggests that Congress intended to require more than that a "family farmer" be engaged in a farming operation during the taxable year preceding the year in which the petition was filed. If Congress intended to focus only on this time period, the "engaged in a farming operation" language would be superfluous since it would appear that an individual who, for the taxable year preceding the year in which the petition is filed, incurred "at least 80% of his debt and received at least 50% of his income from a farming operation he owned or operated, as required by § 101(17)," would necessarily have been engaged in a farming operation during that same time period. A statute should not be interpreted so as to render one part inoperative, superfluous or insignificant.

Tart, 73 B.R. at 81.

Courts are divided as to what "engaged in a farming operation" actually requires, however. Some courts have placed a requirement on debtors that they must intend to carry on a farming operation throughout their chapter 12 plan and that continuing such an operation is realistic. *See id.* (holding that debtors who had minimally engaged in farming during the taxable year preceding the taxable year in which their petition was filed, who had sold all their farmland prior to the filing of their petition, and who do not intend to resume any farming operations, did not qualify for relief under chapter 12 because they were not engaged in farming as required under 11 U.S.C. § 101(18)); *In re Buckingham*, 197 B.R. 97, 104 (Bankr. D. Mont. 1996) (holding that "engaged in a farming operation" requires that a chapter 12 petitioner "must engage in at least some farming operations over the entire duration of the plan, even if on a cyclical or reduced basis" and debtors need to provide a detail of realistic and concrete future farming plans); *In re Rott*, 73 B.R. 366, 371 (Bankr. D. N.D. 1987) ("The court does not believe that farmers forced to partially liquidate assets or temporarily rent out machinery or farmland, in an effect to salvage their farm operation, should be foreclosed from seeking relief under Chapter 12."). These courts point to the legislative history surrounding enactment of chapter 12, which specified that the primary purpose of chapter 12 was "to help family farmers continue farming" and "to give family farmers facing bankruptcy a fighting chance to reorganize their debts and keep their land." *Tart*, 73 B.R. at 81 (noting specifically that debtors who had ceased notable farming operations before filing for bankruptcy, and who had sold all their farmland and did not intend to resume farming operations did not qualify for chapter 12); *In re Indreland*, 77 B.R. 268 (Bankr. D. Mont. 1987) (concurring with reasoning in *Tart*).

Other courts have held that a debtor need not continue a farming operation, or even represent that he or she will do so, in order to qualify for chapter 12. These courts only require that a debtor be engaged in a farming operation at the time of filing bankruptcy. *Nelson*, 291 B.R. at 870 (debtors who ran a farm operation on the date of petition, but later discontinued that operation, were nonetheless eligible for chapter 12 relief); *Clark*, 288 B.R. at 245–47 (concluding that the Bankruptcy Code did not require that a debtor must continue to satisfy the test for a "family farmer" throughout the pendency of the case or through completion of the plan of reorganization—eligibility should only examined as of the time of filing the bankruptcy petition); *Lockard*, 234 B.R. 484 (holding that debtors who no longer lived on the farm property, who had turned over the farm operation to a hired manager, and who had entered into a lease/purchase agreement with the manager for the eventual sale of the farm operation nonetheless qualified for chapter 12).

PRACTICE TIP

A debtor that meets the income and debt requirements previously discussed in this section may nonetheless fail to satisfy the "engaged in a farming operation" requirement if farming activities, as defined in statute and case law, have been abandoned or suspended.

Eligibility is normally determined by the debtor's originally filed schedules. However, other relevant facts may be considered if the scheduled claims are greater than the amounts disclosed. *In re Osborne*, 323 B.R. 489 (Bankr. D. Or. 2005).

PRACTICE TIP

The definition of "family farmer" should not be confused with the definition of "farmer" provided in 11 U.S.C. § 101(20). That subsection defines "farmer" as a person that received more than 80 percent of their gross income from a farming operation during the taxable year preceding the year of filing. The definition in section 101(20) does not apply to provisions in the Bankruptcy Code that specifically use the term "family farmer."

A debtor that is a corporation or a partnership is a family farmer if the following conditions are met:

1. More than 50 percent of the outstanding stock or equity is held by one family or by one family and relatives of the members of such family.

2. The family holding the stock or the relatives holding the stock conduct the farming operation.

3. Aggregate debts do not exceed $4,153,150. This debt limit is adjusted based on the consumer price index.

4. Not less than 50 percent of aggregate noncontingent, liquidated debts arise out of the family operation owned or operated by the corporation or partnership on the date of filing. "[A] debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence" is excluded from this calculation, unless such debt arises out of a farming operation.

5. If the debtor is a corporation that issues stock, the stock must not be publicly traded.

11 U.S.C. § 101(18)(B).

The term "corporation" includes:

(i) an association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;

(ii) a partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;

(iii) a joint-stock company;

(iv) an unincorporated company or association; or

(v) a business trust;

but does not include, a limited partnership.

See In re Ralph Faber Trust, 113 B.R. 599 (Bankr. N.D. 1990). Land trusts are not eligible for chapter 12 relief. *Id*. Probate estates are likewise not eligible for chapter 12 relief. *See In re Estate of Grassman*, 91 B.R. 928 (Bankr. D. Or. 1988).

There is no requirement for a family farmer corporation or partnership that over 50 percent of its gross income be received from the farming operation. *In re Cross Timbers Ranch, Inc.*, 151 B.R. 923 (Bankr. W.D. Mo. 1993). However, courts have consistently held that the family or relatives holding the stock in the company must be actively conducting the operation when the bankruptcy is filed. *See In re Burke*, 81 B.R. 971, 976 (Bankr. S.D. Iowa 1987) (corporate debtor which leases farmland to tenant under crop share arrangement considered "engaged in farming" only if family members of debtor "take an active role in the operation"). The "conduct" element of section 101(18)(B) serves to exclude from chapter 12 eligibility those corporations which bear an attenuated connection with the farming operation itself. *See In re Mary Freese Farms, Inc.*, 73 B.R. 508, 511 (Bankr. N.D. Iowa 1987) (where tenant farmer "makes all of the management decisions and does all of the 'hands-on' planting and harvesting," corporate debtor does not "conduct" the farming operation); 132 Cong. Rec. 9985 (1986) (statement of Sen. McConnell) ("[A] corporation who [sic] seeks to file under chapter 12 must have 50 percent of its stock or equity owned by a person who is actually farming."). The "conducting" eligibility requirement for corporate debtors and the "engaged in" eligibility requirement appear to be nearly, if not completely, identical. Many of the issues, such as whether the farming operation must actually continue post-petition, are also the same. *See In re Mikkelsen Farms, Inc.*, 74 B.R. 280, 285 (Bankr. D. Or. 1987) (though corporate debtor leased all of its farmland in crop year 1987, debtor was eligible for chapter 12 relief because it, through its principals, had planted and harvested crops in 1986, the year in which it filed its petition).

4. Regular Income Requirement

A debtor that qualifies as a family farmer must also have "regular annual income." According to the Bankruptcy Code, this means that the family farmer must have annual income that is sufficiently stable to make payments under the chapter 12 plan. 11 U.S.C. § 101(19). In contrast to chapter 13 requirements of "regular income," this provision is tailored to assist farmers who naturally experience irregular income streams due to seasonal harvests and lengthy maturing schedules for poultry and animals. Payments are generally made on an annual basis, or on another periodic schedule agreed to by the trustee and creditors, and approved by the court.

COMMENT

The debt limits discussed earlier in this section are current as of April 1, 2016 and are adjusted every three years. For a listing of all adjusted dollar amounts in the Bankruptcy Code, consult the Federal Register's publication titled "Revision of Certain Dollar Amounts in the Bankruptcy Code," accessible on the Government Publishing Office website at <https://www.gpo.gov/fdsys/pkg/FR-2016-02-22/pdf/2016-03607.pdf>.

§ 20.2 COMMENCING THE CHAPTER 12 CASE

A. Meeting with the Client

In order to provide proper guidance and to achieve plan confirmation, the attorney needs to know all of the facts involving a client's financial situation. Gathering accurate information from the client is of paramount importance.

In contrast to nearly all chapter 13 filings, and adding to the stress of the client, achieving plan confirmation in chapter 12 can be very contentious. The income, debt, and asset requirements discussed above place an additional burden on a debtor to establish eligibility. Although many individuals and corporations will easily satisfy chapter 12 eligibility requirements, attorneys should take care to clearly document and distinguish all of the income and debts as they relate to the different income-producing activities of the client. Among other information, the client should disclose the following, in detail:

- a list of all names and addresses used in the last six years;
- a Social Security number and picture identification;
- all sources of income for the past three years;
- a list of all property owned and approximate values, with detailed lists of those holding ownership interests in the property;
- itemization of property actually used for "farming operations" as defined in the Bankruptcy Code;
- a list of all creditors and the amounts due;
- the roles of the client and his or her family members in the farming operation;

- articles of incorporation, bylaws, and shareholder information, if any;
- income taxes for the last three years, including all schedules;
- detailed accounts of monthly expenses, including rent or house payments, utilities, food, transportation, insurance, child care, and other miscellaneous expenses;
- a list of all monies owed to the client and a description of any other claims against third parties, including any personal injury claims and workers' compensation claims;
- any litigation or actions against the client, or any dates of any important events, such as foreclosure sales and repossessions of equipment;
- lists of all contracts and accounts receivable;
- all financial statements provided to banks or financial institutions in the last two years;
- payments made within 90 days of filing, and payments to family members or insiders within one year of filing;
- past modifications to the farming operation;
- planned future modifications to the farming operation, if any; and
- credit resources available to the client to finance future operations.

PRACTICE TIP

If the client is a corporation, care must be taken to differentiate the assets and liabilities of the corporation versus those of the individuals owning and operating the corporation. Attorneys should also note that, due to federal farm program payments, a client may use one entity to own the farm assets and another entity to operate the farm. A client will likely not make the distinction when speaking about the financial condition of the farm. However, such a distinction is vital in determining whether a client is eligible for chapter 12 relief.

All of this information is important in developing a picture of both the financial condition of the enterprise and the individuals involved in the enterprise. As with any other bankruptcy filing, proper and timely debt relief agency disclosures must be provided to the client. *See* 11 U.S.C. § 527.

B. Advising the Client

Once the client's documentation has been reviewed and the interview process completed, the client must be advised of the ramifications of filing under chapter 12 versus other chapters. The client should also be advised of the exemption issues and other issues the debtor might face if voluntarily converting to another chapter. The client will also need to be told how the bankruptcy process works and what their responsibilities will be in that process, including attending the meeting of creditors, continuing to operate the farm as a debtor in possession, and providing the trustee with the required financial information. Perhaps most importantly, the client should be advised of the time commitment of, and problems that could arise in, a chapter 12 case. Attorneys should take care to avoid focusing on the best-case scenario, and discuss the practical realities and difficulties of success in a lengthy chapter 12.

PRACTICE TIP

Although similar in many ways to chapter 13, chapter 12 requires additional expertise and/or research in the field of agribusiness. Attorneys must be aware of their own limitations and experience levels. If a client's case seems too complicated and convoluted, seriously consider denying representation of that client.

C. Gathering Information

If the client decides to go forward with the bankruptcy proceeding, the client should be asked to complete a set of worksheets, and to gather information supporting the statements contained in those worksheets. It is important to have the client complete the worksheets, because doing so will help ensure that the client is including all the relevant information, and that the attorney has a record of the client's answers.

PRACTICE TIP

Attorneys should be aware that information contained in the worksheets discussed above may be discoverable in future bankruptcy litigation. *See In re Wilkerson*, 393 B.R. 734 (Bankr. D. Colo. 2007) (information provided to a bankruptcy attorney for the purpose of completing bankruptcy schedules is not privileged because there is no intent that the information be held in confidence—the information is to be disclosed on documents publicly filed with the bankruptcy court).

D. Preparation of the Schedules

Although the bankruptcy schedules are quite straightforward, there are a few items that should be kept in mind when completing them.

1. Schedule A/B – Real Property

- List the address, legal description, county, and state in which the property is located.
- Include all real property interests, including remainder interests, unexpired redemption rights in foreclosed properties, timeshares (if real property), etc.
- Verify the debtor's legal title to the property—exclusive ownership should not be assumed.
- Review mortgage records, Uniform Commercial Code records, and DMV records.

- Recent appraisals of the property (i.e., for a refinancing) are helpful in determining the value of the property. Most trustees look at the estimated market value for property taxes as an objective indicator of the current value of real property. Realtors' opinions, comparative market analyses, online sources, and other methods can also be helpful, and should be noted on the schedules.

2. Schedule A/B – Personal Property

- Note the importance of accuracy in listing of personal property, especially regarding bank balances. *See Barrows v. Christians*, 408 B.R. 239 (B.A.P. 8th Cir. 2009) (bankruptcy court did not abuse its discretion in denying debtors' asserted exemption in a bank account balance the debtors failed to initially disclose on their schedules).
- Redact bank account numbers.
- Ensure proper categorization of property.
- If the debtor does business under a corporate name—or did business, and the corporation was never formally dissolved—the debtor's interest in the corporation should be listed on line 13.
- Provide vehicle and property identification numbers, if possible.
- Provide a complete listing of all farm machinery and equipment.
- Provide a complete listing of all harvested crops and growing crops.
- Provide an itemized listing of all livestock.

PRACTICE TIP

Resources that gather public data, such as Westlaw's PeopleMap, are useful tools for practitioners in ensuring that clients are being forthcoming with their assets.

3. Schedule C – Exemptions

Individual debtors are entitled to claim exemptions under 11 U.S.C. § 522. However, corporations are not entitled to claim exemptions in almost all circumstances. *See* 11 U.S.C. § 522 ("an individual debtor may exempt…."). In a notable exception, the Minnesota Court of Appeals, applying the reverse-piercing doctrine, allowed a married couple that owned 100 percent of the stock of a family farm corporation to exempt 80 acres owned by the corporation pursuant to the Minnesota homestead exemption. *State Bank in Eden Valley v. Euerle Farms, Inc.*, 441 N.W.2d 121 (Minn. Ct. App. 1989). In other words, the court allowed the couple to disregard the corporate entity, with the trial court noting the close identity between the couple and the corporate entity, and the alter-ego nature of the relationship between the two. *Id.*

When reviewing an exemption claim based on the reverse-piercing doctrine, Minnesota courts consider: (1) "the degree of identity between the individual and his or her corporation" and "the extent to which the corporation is an alter ego"; and (2) "whether others, such as a creditor or other shareholders, would be harmed by a pierce." *Cargill, Inc. v. Hedge*, 375 N.W.2d 477, 480 (Minn. 1985); *see also Roepke v. W. Nat'l Mut. Ins. Co.*, 302 N.W.2d 350, 352 (Minn. 1981) (allowing reverse-piercing where the insider "owned all, or substantially all, of the stock," "treated the property as his own," and "no shareholder or creditor would be adversely affected" by the piercing). An insider seeking reverse-piercing is required to demonstrate "that it was unfair and unjust not to pierce the corporate veil." *Miller & Schroeder, Inc. v. Gearman*, 413 N.W.2d 194, 196–97 (Minn. Ct. App. 1987).

In a high-profile Minnesota bankruptcy case, the court denied Denny Hecker's bid to reverse-pierce the corporate veil to exempt a homestead held in the name of a limited liability company in which Hecker owned substantially all of the stock. *In re Hecker*, 414 B.R. 499 (Bankr. D. Minn. 2009). In finding that the limited liability company was not Hecker's alter ego, the court noted the large web of interconnected businesses run by Hecker through his limited liability companies. *Id.* Case law indicates that courts will analyze reverse-piercing theories on a case-by-case basis, and that the sophistication of the debtor and the integration of the debtor may play a role in the analysis.

4. Schedule D – Secured Creditors

All creditors holding collateral should be listed, with full names and addresses of the creditors, the loan or account numbers, descriptions of the collateral, values of the collateral, lien priority, and the balance due on the obligations. Property taxes should also be listed in Schedule D.

5. Schedule E – Priority Creditors

All priority claims, as defined under 11 U.S.C. § 507, should be listed here.

6. Schedule F – General Unsecured Creditors

All general unsecured creditors should be listed here.

PRACTICE TIP

Use complete names and addresses. It is best practice to list all attorneys, collection agencies, alternate addresses, etc. Over-noticing is better than under-noticing.

7. Schedule G – Executory Contracts and Unexpired Leases

A debtor under chapter 12 may have executory contracts for the sale of grain, animals, or poultry. Farmers also often raise livestock without owning them. The debtor may also have long-term real property and equipment lease obligations. Moreover, a debtor must assume Farm Service Agency (FSA) and Conservation Reserve Program (CRP) contracts to receive government payments.

PRACTICE TIP

The terms of each lease should be closely reviewed to determine the length of the lease, the nature of the payment terms (including cash rent or any sharecropping arrangement) and due dates, and any automatic renewal provisions. If any lease payments will come due post-petition, those leases should be dealt with soon after filing. *See infra* section 20.9.

8. Schedule H – Co-Debtors

There may be many co-debtors and significant amounts of scheduled debt in which there are co-obligors. Schedule H should contain the name and address of anyone who is a co-debtor on one or more of the debts. The specific debts that apply to each co-debt should be listed.

PRACTICE TIP

A debtor's divorce decree only determines liability as between the debtor and the debtor's ex-spouse. Unless the creditor has specifically removed the former spouse from the joint debt or account, the former spouse is still liable, notwithstanding the divorce decree, and he or she should be listed here.

9. Schedule I – Summary of Income; Schedule J – Current Expenditures

Chapter 12 debtors will complete schedules identical to those completed by chapter 13 debtors. Individual chapter 12 debtors should complete Schedules I and J as one would in chapter 13, where a chapter 13 debtor has business income and expenses. This includes filing a detailed business income and expense statement. Corporate debtors need to provide a detailed business income and expense statement. Because the other expenses on Schedules I and J are unique to individuals, a corporation is not entitled to take any other expenses on Schedule J. Whether an individual or a corporation, the debtor should file a detailed "business income and expense" declaration with the court. In both circumstances, the trustee will send a business questionnaire to the debtor. The trustee will request that the questionnaire be returned prior to the section 341 meeting of creditors.

E. Valuation Issues

A debtor's valuation of property is relevant to a number of aspects of a chapter 12 case, including, but not limited to, demonstrating that 80 percent of the value of a corporate debtor's assets are related to a farming operation, and modifying secured creditors' rights through lien-stripping. In the context of determining the secured status versus the unsecured status of a claim, value of property is determined "in light of the purpose of the valuation and of the proposed disposition of use of such property." 11 U.S.C. § 506(a)(1). Because debtors have the ability to strip liens, including first mortgages, the valuation of assets is often a point of contention between debtors and creditors. A court may determine the value of a claim secured by a lien on motion of any party in interest. Fed. R. Bankr. P. 3012.

In *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997)—a seminal case on bankruptcy valuations in chapter 13—the Supreme Court concluded that replacement value was the appropriate measure of value where the debtor retains collateral. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. *Assocs. Commercial*, 520 U.S. 953 at 965 n.6. The court held that in the chapter 13 context, the replacement value "is the cost the debtor would incur to obtain a like asset for the same 'proposed … use.'" *Id*. In chapter 12 cases decided both before and after *Rash*, courts have utilized the same factors in determining the value of collateral, and noted that it is the debtor's proposed use that is controlling, even if the debtor's proposed use is not the "highest and best use." *See In re Brace*, 163 B.R. 274, 277 (Bankr. W.D. Pa. 1994) ("we are persuaded that the Debtors' current and prospective use is the correct basis for the appraisal in determining the amount of the lender's secured claim"); *In re Bishop*, 339 B.R. 595 (Bankr. D. S.C. 2005) (concluding that the United States Department of Agriculture's "highest and best use" valuation was not appropriate measure of value—valuation of the collateral is based upon the debtor's proposed disposition or use of the property); *In re Donato*, 253 B.R. 151 (M.D. Pa. 2000) (federal district court affirmed the bankruptcy court's conclusion that the debtor's proposed use was the appropriate measure of value, not the Internal Revenue Service's expert's valuation based on the property's "highest and best use").

It appears that courts will take a two-step approach to determine values in chapter 12 cases. The court will first discern the debtor's proposed use of property, and then consider evidence to determine the value of said property in that type of usage. *See*, *e.g.*, *In re McElwee*, 449 B.R. 669 (Bankr. M.D. Pa. 2011); *In re Abruzzo*, 249 B.R. 78 (Bankr. E.D. Pa. 2000); *In re Serda*, 395 B.R. 450 (Bankr. E.D. Cal. 2008). Such valuations are fact intensive determinations, and bankruptcy courts determine the appropriate valuation methodology based on the parties' evidence of the debtor's situation and the property's characteristics. *In re Henry*, 457 B.R. 402, 406–07 (Bankr. E.D. Penn. 2011).

F. Attorney Employment and Conflicts of Interest

An attorney must make an application to represent a chapter 12 debtor pursuant to 11 U.S.C. § 327 and Minnesota Local Rule of Bankruptcy Procedure 2014-1(a). *See also infra* section 20.4.A. An attorney seeking to represent a chapter 12 debtor must also meet the application requirements of Federal Rule of Bankruptcy Procedure 2014, setting forth the attorney's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee. Particular care regarding conflicts of interest should be taken if a corporation, partnership, or other limited liability entity and its principals seek to file separate chapter 12 bankruptcies. *See In re Big Mac Marine, Inc.*, 326 B.R. 150 (Bankr. 8th Cir. 2005) (holding that an attorney who represents a debtor's principals in their individual bankruptcy was disqualified, based on an actual conflict of interest, from representing the debtor); *see also In re Wiley Brown & Assocs., LLC*, No. 06-50886, 2006 WL 2390290, at *4 (Bankr. M.D. N.C. Aug. 14, 2006) ("It is a conflict of interest to represent a debtor and an owner of the debtor."); *In re TMA Assocs., Ltd.*, 129 B.R. 643, 647 (Bankr. D. Colo. 1991) ("An attorney is at peril when simultaneously representing a partnership and its general partner.").

§ 20.3 THE CHAPTER 12 TRUSTEE

A. Assignment

The chapter 12 trustee is either a standing trustee, a case-by-case trustee, a disinterested person appointed by the United States Trustee, or the United States Trustee. In Minnesota and North Dakota, the chapter 12 trustee is assigned on a case-by-case basis. 11 U.S.C. § 1202(a).

The chapter 12 trustee for Minnesota and North Dakota is:

Kyle Carlson
55 2nd Ave. SW, P.O. Box 519
Barnesville, MN 56514
Phone: (218) 354-7356
Fax: (218) 354-2235
Email: info@carlsonch13mn.com

B. Duties and Powers

A chapter 12 trustee performs many of the same duties as a chapter 13 trustee, and has the similar central duty of distributing to creditors moneys received from debtors. *See* 11 U.S.C. §§ 1202; 1302. The trustee must appear at any hearing concerning the value of property subject to a lien, confirmation of the plan, modification of the plan, or the sale of estate property. 11 U.S.C. § 1202(b)(3). The chapter 12 trustee will also be required to conduct the debtor's business (in a capacity similar to that of a chapter 11 trustee) only if the debtor ceases to be a debtor in possession. 11 U.S.C. § 1202(b)(5). As in chapter 13, the chapter 12 trustee takes an active position in ensuring the debtor meets the disposable income test, best interest of creditors test, and other requirements of 11 U.S.C. §§ 1222 and 1225.

While the chapter 12 trustee cannot give legal advice, the trustee does have a duty to advise the chapter 12 debtor on matters relating to the plan that do not involve legal advice.

§ 20.4 DEBTOR IN POSSESSION

A. Duties and Powers

A chapter 12 debtor has all of the rights and duties of a chapter 11 trustee other than investigating its own affairs and being entitled to compensation. 11 U.S.C. § 1203. The chapter 12 debtor operates as a debtor in possession and has the ability to enter into transactions, including the sale or lease of property of the estate. 11 U.S.C. § 363(b) & (c). Because chapters 1, 3 (except for section 361), and 5 of the Bankruptcy Code apply to cases under chapter 12, a debtor *may not*:

- retain or employ attorneys, accountants, appraisers, auctioneers, or other professional persons without court approval. This includes employing a petition-filing attorney the debtor desires to obtain services from after the filing, 11 U.S.C. § 327;
- compensate any attorney, accountant, appraiser, auctioneer, or other professional person, except as allowed by the court, 11 U.S.C. § 330;
- use, sell, or lease property of the estate out of the ordinary course of business without prior court authorization, 11 U.S.C. § 363(b)(1);
- use, sell, or lease cash collateral (or cash equivalent) without the consent of the secured creditor or court authorization, 11 U.S.C. § 363(c)(2) & (4) ("cash collateral" includes proceeds, products, offspring, rents, or profits of property subject to a security interest when reduced to cash);
- obtain credit or incur unsecured debt other than in the ordinary course of business without court authorization, 11 U.S.C. § 364(b);

- incur secured debt without court authorization, 11 U.S.C. § 364(c); or
- pay any creditor for goods or services provided before the filing of the petition, except as provided in a confirmed plan, 11 U.S.C. § 549.

PRACTICE TIP

Generally, any activity outside of the ordinary course of business requires notice, hearing, and court approval. *See* 11 U.S.C. § 364(b). It is sound practice to contact the chapter 12 trustee and any parties asserting a security interest in property to be sold if an activity is arguably outside the ordinary course of business.

B. Removal

A debtor in possession may be removed by the court for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after commencement of the case. 11 U.S.C. § 1204. The chapter 12 trustee is tasked with conducting the debtor's business, with all the debtor in possession's powers, if the debtor loses debtor in possession status. 11 U.S.C. § 1202(b)(5).

C. Debtor Information/Reports/Documents to Provide to Trustee

The debtor is required to cooperate with the United States Trustee and the appointed chapter 12 trustee. 11 U.S.C. § 521. The debtor should produce information requested by the United States Trustee and the chapter 12 trustee in supervising the administration of the debtor's estate, including regular reports on the operation of the debtor's farming enterprise. Upon filing a chapter 12 bankruptcy, the debtor and the debtor's attorney will receive a letter and email from the chapter 12 trustee requesting information, along with materials to be completed. Failing to provide the requested information and monthly operating reports will result in a motion to dismiss being filed by the chapter 12 trustee. *See In re Kerr*, 908 F.2d 400, 404 (8th Cir. 1990) (affirming dismissal of chapter 11 petition for bad faith where debtors violated court order by failing to provide monthly financial reports).

PRACTICE TIP

These documents should be submitted to the chapter 12 trustee, not the United States Trustee.

The chapter 12 trustee will ask the debtor to provide the following financial information:

1. **Summary of operations for chapter 12 case (*see infra* Appendix A):** This is an informational report reflecting the debtor's farm operation, including total acreage, tillable acreage, results of the past year's operation, and estimates or projections for the current or next crop year. This form must be completed and received in the chapter 12 trustee's office at least five days prior to the first meeting of creditors. Failure to submit the completed summary of operations at least five days prior to

the first meeting of creditors may result in the first meeting of creditors being continued to another date.

2. **Monthly cash receipts and disbursements statement (*see infra* Appendix B):** The debtor must report not later than the 10th day following the end of the month all of his or her income in cash, check, or otherwise (including government program payments of any nature) received during the month. This report must be filed with the chapter 12 trustee. The receipts should be itemized by kind, quantity, and dollar amount (for example, "Sold 2,000 bushels of corn to Co-op Elevator at $1 per bushel = $2,000"; "Sold 10 beef cattle to Acme Sale Barn for $59 per hundred weight = $4,000"; "Sold 5 tons of hay at $55/ton to Joe Smith = $275"). Likewise, all expenses paid in cash or by check must be itemized. Operating expenses must be itemized under appropriate headings such as "fuel," "feed," "veterinarian expense," "repairs," etc. The portion of the form calling for monthly cash reconciliation must be properly completed. When the first report is filed, the report should include all receipts and disbursements since the filing of the petition. The debtor must attach to each monthly report a copy of the monthly statement for every bank account maintained by the debtor.

3. **Tax deposit statement (*see infra* Appendix C):** If the debtor is a family farm corporation, or if the debtor has employees who are subject to withholding or Social Security taxes, the debtor must complete the tax deposit statement and provide evidence of payment.

4. **Insurance statement:** Prior to the section 341 meeting, the debtor must provide the chapter 12 trustee with documentation of fire and extended coverage on the debtor's buildings, equipment, and motor vehicles. Where there is no insurance coverage in place, the debtor must explain why there is no insurance coverage. The debtor should notify the chapter 12 trustee of any lapse, cancellation, or proposed cancellation of any insurance coverage. A debtor's failure to provide insurance coverage may result in motions for relief from stay and motions to dismiss the case. *See In re Pertuset*, 492 B.R. 232, 252 (Bankr. S.D. Ohio 2012) ("The Debtors' failure to provide insurance for the Creditors' collateral is further indicia of gross mismanagement that is prejudicial to creditors" and is cause for dismissal).

5. **Reporting of debtor in possession bank accounts (*see infra* Appendix D):** All pre-petition bank accounts and investment accounts open on the day of filing in which the debtor has an interest, possession, custody, control, ownership, or access must be disclosed to the chapter 12 trustee. All bank accounts opened or maintained by the debtor subsequent to filing (including general checking and savings accounts, payroll, tax escrow accounts, cash collateral accounts, and certificates of deposit) must be reported to the chapter 12 trustee on the bank account reporting form. The debtor must also attach to the form a copy of the most recent bank statement received by the debtor for each pre-petition account disclosed to the trustee. This form, with the attached bank statements, must be submitted to the chapter 12 trustee prior to the section 341 meeting, and again within 10 days of the opening or closing of any post-petition accounts. In addition, the debtor must attach to the monthly receipts and disbursements statement copies of all monthly bank statements for accounts corresponding or relating to the month and/or period for which the financial report is being filed.

6. **Bank statements for the three months preceding the filing of the petition:** The trustee will request three months of bank statements preceding the filing of the bankruptcy. Submission of these

documents to the trustee's office prior to the 341 meeting of creditors will assist the trustee in conducting the meeting. These documents should also be brought to the meeting for review.

7. **Proof of secured status:** The chapter 12 trustee checks security agreements and UCC filings to ensure that secured creditors have valid and perfected security interests. If a chapter 12 debtor, as a debtor in possession, fails to avoid an unperfected security interest, the plan may ultimately fail to satisfy the mandate of 11 U.S.C. § 1222(b)(1) that the plan not discriminate unfairly against a class or classes of unsecured creditors. *See In re Arnold*, 88 B.R. 917 (Bankr. N.D. Iowa 1988) ("A statutory lien for rent is avoidable. 11 U.S.C. § 545(3); *see also* 11 U.S.C. § 544(a). If avoided, it is preserved for the benefit of the estate. 11 U.S.C. § 551. To the extent that Debtors, as debtors-in-possession under 11 U.S.C. § 1203, have elected not to avoid Lessor's lien, they have treated him favorably. This favorable treatment of Lessor, without cause, does not meet the mandate of § 1222(b)(1)…").

D. Debtor's Duty to File Tax Returns

It is the responsibility and duty of the debtor to prepare and file the debtor's own federal tax returns. The specific mandate found in I.R.C. §§ 6012(b)(4) and 1398(a) (requiring the filing of tax returns by the trustee on behalf of the estate in chapters 7 and 11) fails to include estates under chapter 12. Therefore, the chapter 12 trustee is freed from any obligation to file federal returns on behalf of the estate. The debtor must prepare and file the return. The trustee requires that the debtor provide copies of all federal tax returns filed by the debtor for any period commencing with the filing of the chapter 12 petition through the completion of the confirmed plan.

PRACTICE TIP

Because complex tax issues may arise as the result of a chapter 12 filing (i.e., the separate entity rules do not apply to estates under chapter 12), it is advisable for the debtor to retain a qualified tax preparer to file the debtor's tax return. Neither the United States Trustee nor the chapter 12 trustee is permitted to give any tax advice to the debtor.

§ 20.5 FORMULATING AND FILING A CHAPTER 12 PLAN

A. General

A plan is required, and chapter 12 debtors have 90 days to file the plan, except that the court may extend the 90-day window "if the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable." 11 U.S.C. § 1221. Courts have generally viewed the 90 days window to file a plan as a hard deadline. A debtor's failure to file a plan within that period, failure to request an extension prior to the lapsing of that period, or failure to justify an extension of the window will likely result in dismissal of the case. As the Bankruptcy Court for the District of Idaho has indicated "[t]he standard under § 1221 for the filing of a plan is a strict one" and the "language [of section 1221] is not reasonably subject to debate." *See In re Marek*, 468 B.R. 406 (Bankr. Idaho 2012). And as noted in *Collier*'s:

> [T]he 90-day limitation [in 11 U.S.C. § 1221] was probably included in chapter 12 for the benefit of creditors rather than for the benefit of the debtor. Because chapter 12 lacks the safeguards for creditors that are provided in chapter 11, the 90-day limitation, together with the 45-day limitation of section 1224, is the primary protection for creditors against a debtor's languishing in chapter 12 without confirming a plan. Thus, it is appropriate that the debtor should be required to meet a stringent burden if the debtor seeks an extension of the 90-day period. The court should allow an extension only if the debtor clearly demonstrates that the debtor's inability to file a plan is due to circumstances that are beyond the debtor's control.

8 Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 1221.01[2], at 1221–23 (16th ed. 2010) (footnotes omitted).

Chapter 12 debtors are not required to file a disclosure statement, and are not required to obtain creditor consent to the plan; but, as in chapter 13, creditors and any other party in interest may object to the plan. 11 U.S.C. § 1224.

B. Drafting the Plan

Local rules do not require the use of a local form for a chapter 12 plan. *Cf.* Minn. Bankr. L.R. 3015-1 (requiring the use of Local Form 3015-1 for chapter 13 plans). The plan may be much more extensive than a chapter 13 plan; however, many of the plan requirements will be identical to chapter 13.

1. Mandatory Provisions – 11 U.S.C. § 1222(a)(1)–(3) and (c)

- All disposable income must be paid to the chapter 12 trustee.
- Priority claims must be paid in full. Priority administrative expenses (11 U.S.C. § 507(a)(2)) must be paid before or at the time of each payment to creditors under the plan.
- The plan must provide the same treatment for each claim or interest within a particular class, if the plan classifies claims.
- A three-year repayment plan is required. The repayment period may be extended for an additional two years to cure arrears on unsecured and secured long-term debts.

2. Permissible Provisions – 11 U.S.C. § 1222(b)

- The plan may create classes of unsecured nonpriority claims, so long as they are treated fairly. This provision generally allows debtors to discriminate in favor of non-filing third party co-debtors. Courts have developed a four-part test to determine whether a proposed separate classification of unsecured claims is fair, by inquiring: (1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination. *See*, *e.g.*, *In re Leser*, 939 F.2d 669 (8th Cir. 1991); *In re Wolff*, 22 B.R. 510, 512 (B.A.P. 9th Cir. 1982).
- The plan may modify the rights of unsecured creditors (in other words, not provide for payment in full of unsecured claims).

- The plan may modify the rights of secured creditors. Chapter 12 debtors may "cramdown" an undersecured creditor's secured claim to the present value of the collateral (pursuant to 11 U.S.C. § 506(a)) and strip the unsecured share of the lien from the claim. This leaves a lien on the collateral equaling the amount of the secured claim, and an unsecured claim for the stripped-away amount. *See* 11 U.S.C. § 1222(b)(2). Debts for secured vehicles purchased within 910 days preceding filing ("910 car" claims), debts secured by other collateral incurred within one year prior to filing, or partially secured debts secured by mortgages on the debtor's primary residence cannot be crammed down and lien-stripped in a chapter 13. *See* 11 U.S.C. § 1325(a)(9). No such anti-modification rule exists in chapter 12. This collateral can be crammed down in a chapter 12, stripping the unsecured portion of the lien from the collateral.

PRACTICE TIP

A debtor's valuation of an asset in the cramdown context will likely face resistance from the secured creditor. Under 11 U.S.C. § 506(a)(1), "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question." *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 962 (1997). Ultimately, the value of a debtor's property is "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." *Id.* at 960. Appraisals, evidentiary hearings, and testimony of expert witnesses should be expected as additional costs and time commitments if a cramdown is contemplated. *See also supra* section 20.2.E.

- The plan may cure or waive defaults.
- The plan may cure defaults and maintain payments on long-term debt. This provision allows a debtor to cure defaults within a reasonable time and maintain payments on debts that come due after the last plan payment is due.
- The plan may provide for payment of secured claims and unsecured claims concurrently.
- The plan may assume, reject, or assign unexpired leases and executory contracts.
- The plan may use estate property to pay all or part of claims. In other words, the debtor need not rely solely on future income to make plan payments.
- The plan may provide for the vesting of property, at plan confirmation or later, in the debtor or another entity. Note that property will automatically vest in the debtor at plan confirmation, absent plan provisions or the order confirming the plan directing otherwise. *See* 11 U.S.C. § 1227.
- The plan may provide for payment of interest accruing post-petition on nondischargeable unsecured claims, if the plan makes provisions for payment in full of all allowed claims.

Modification of a secured debt that is allowed under chapter 12 is not only the modification of the amount secured by the loan. The interest rate and the term of the loan can also be modified.

3. Modification of Interest Rates

The Supreme Court, in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), held that interest rates (other than on loans secured solely by the debtor's primary residence) can be reduced to the prime rate, plus a risk factor of up to three percent. Courts consider the duration of the plan, the feasibility of the plan, the risk of default, and the nature of the security as factors that can be taken into consideration when choosing an interest rate. *See In re Fowler*, 903 F.2d 694, 697–98 (9th Cir. 1990); *In re Wilson*, 378 B.R. 862 (Bankr. D. Mont. 2007). Risk is heightened to an extent in chapter 12 based on the unpredictable nature of the agricultural economy. *See Fowler,* 903 F.2d 694; *Wilson,* 378 B.R. 862; *see also United States v. Doud*, 869 F.2d 1144, 1145 (8th Cir. 1989). Although *Till* involved a chapter 13 case, the *Till* approach has been applied in the chapter 12 context. *See*, *e.g.*, *In re Torelli*, 338 B.R. 390 (Bankr. E.D. Ark. 2006); *Wilson*, 378 B.R. 862.

4. Modification of Loan Terms

Plans are limited in length to 36 months in chapter 12, with courts given discretion to approve an additional 24 months. 11 U.S.C. § 1222(c). As in chapter 13, on any long-term unsecured or secured debts (i.e., debts maturing after the date of the final plan payment), payments may be cured and maintained during the term of the plan, and continue beyond the term of the plan. *See* 11 U.S.C. §§ 1222 (b)(5) & (c). A common example is a mortgage payment that is maintained at the contract rate of payment during the plan and after completion of the plan. Exclusively in chapter 12, however, short- and long-term secured debts (i.e., debts maturing either before or after final plan payment) may be restructured to provide for a modified payment beyond the term of the plan, "as long as the Plan upon confirmation provides that the secured creditors will retain the lien securing the claim and be paid present value of the allowed claim." *In re Martin*, 78 B.R. 598, 602 (Bankr. D. Mont. 1987); *see also* 11 U.S.C. §§ 1222(b)(2) & (9); 1225(a)(5). In other words, any secured claim, including a crammed-down claim, may be modified to extend payments beyond the term of the plan. Contrast this with chapter 13, where a crammed-down vehicle claim, for example, must be paid during the term of the plan.

PRACTICE TIP

Restructuring a secured loan term is not without its limits. The modification of the term of the loan is also subject to scrutiny and courts take into account prevailing lending practices in the region. For example, a court may prohibit the restructuring of a loan for machinery beyond the economic life of the asset. *See In re Ellis*, 478 B.R. 132 (Bankr. N.D.N.Y. 2012) (considering customary lending practices and the risk to the lender in denying a plan under 11 U.S.C. § 1225(a)(5) and (6)); *In re Coleman*, 125 B.R. 621 (Bankr. D. Mont. 1991); *see also infra* section 20.12.C.4.

5. Other General Plan Requirements

- The plan should explicitly provide for the treatment of all claims, whether secured or unsecured. *See In re Citrowske*, 72 B.R. 613, 616 (Bankr. D. Minn. 1987) ("debtor's plan must specify how each creditor's claim will be treated and paid… a plan must provide for payment of all claims").

- The plan should specify whether the payments to a particular class of creditors is to be made directly by the debtors or through the trustee. Language stating that a claim will be paid “inside” or “outside” of the plan is not sufficiently clear. *See In re Pickering*, 195 B.R. 759, 768 (Bankr. D. Mont. 1996) (“All payments to creditors, whether from the Chapter 13 trustee or directly from the debtor, are payments ‘through’ or ‘pursuant’ or ‘under’ or ‘inside’ the Chapter 13 plan. Use of the words ‘inside’ and ‘outside’ is not just misleading; it can be dangerous. The same is true of Chapter 12 because the statutory language on treatment of claims is virtually identical between the two chapters.”).

- The plan should specify the trustee’s fee, which is generally five percent of payments under the plan. *See* 11 U.S.C. § 326(c). The trustee’s preferred language can be requested directly from the trustee.

- The plan should indicate a plan length of not less than three years and not more than five years. *See* 11 U.S.C. § 1222(c) (“…the plan may not provide for payments over a period that is longer than three years unless the court for cause approves a longer period, but the court may not approve a period that is longer than five years.”). The plan length provision does not apply to restructured short and long term debts that provide for a modified payment beyond the term of the plan. *See supra* section 20.5.B.4.

§ 20.6 THE SECTION 341 MEETING OF CREDITORS

A. Preparing for the Section 341 Meeting of Creditors

A chapter 12 meeting of creditors is procedurally identical to meetings for other chapters. Questioning generally follows the same pattern as chapter 13 meetings, but is more intensive, as the trustee will make probing inquiries into the debtor’s income, assets, debts, and plans for the farming operation. Given the number of assets typically involved in a family farmer bankruptcy, the section 341 meeting can be expected to last an hour or more.

Prior to the section 341 meeting, an attorney for a chapter 12 debtor should ensure that the following steps are taken:

- **Tax returns:** Tax returns must be submitted to the trustee seven days prior to the section 341 meeting. Fed. R. Bankr. P. 4002(b)(3). If they are not submitted in time, the section 341 meeting will likely be continued or a motion to dismiss will be filed. Although unlikely in a chapter 12, if the debtor is not required to file a tax return (and has not been so required for a number of years), the debtor is required to provide an affidavit to that effect. If the debtor has not filed the tax returns for the most recent calendar year, the debtor must provide copies of the most recently filed tax returns, with the understanding that the just-concluded year’s tax returns must be submitted to the trustee promptly upon their being filed with the taxing authorities. This includes all schedules filed with the return. Because tax returns are also vital to a debtor’s ability to demonstrate eligibility, it is important that a prospective chapter 12 debtor take steps to file tax returns for all years preceding the year of the bankruptcy filing. *See supra* section 20.1.B.3.

- **Redactions:** Redactions should be made to all tax returns and documents submitted to the trustee to remove sensitive information, such as Social Security numbers, children’s names, and bank account numbers.

- **Pay stubs:** Evidence of the debtor's current income should be acquired, which may include pay stubs from employment outside the farming operation, commissions, or other salary. FED. R. BANKR. P. 4002(b)(2)(A).

- **Account statements:** Statements covering the petition date for each of the debtor's depository institutions' checking, savings, and money market accounts, mutual funds, and brokerage accounts must be brought to the section 341 meeting. FED. R. BANKR. P. 4002(b)(2)(B). This includes IRAs, 401(k)s, 403(b)s, etc. Especially where the debtor has a loan against this type of account, the trustee will insist on the debtor providing copies of the retirement account statement, with the loan information included. Statements must cover the filing date and include balance information. One-line printouts are insufficient, as the trustee will want to analyze transactions both preceding and proceeding the date of filing.

- **Photo identification:** Debtors must bring and present valid photographic evidence for identification purposes. Acceptable forms include a government-issued driver's license or state identification card, passport, or military identification card. Expired and clipped cards are not acceptable. Failure to present valid photo identification will result in continuance of the section 341 meeting or a motion to dismiss.

- **Social Security number:** Debtors must bring and present valid verification of Social Security numbers. A W-2 is acceptable. Failure to present valid Social Security documentation will result in continuance of the section 341 meeting or a motion to dismiss.

- **Other documents:** The trustee will likely ask for copies of divorce decrees, appraisals, or comparative market analyses if property values are based on such items, the non-filing spouse's (or significant other's) pay stub, and other documents relative to developing an accurate picture of the debtor's financial situation.

- **Special requests:** Any requests that deviate from normal procedures (e.g., for an interpreter, or for a telephonic hearing for a homebound debtor) should be made in writing to the United States Trustee's Office in advance of the section 341 meeting.

All items required to be submitted to the chapter 12 trustee should be submitted to the trustee at the trustee's preferred email address, <info@carlsonch13mn.com>.

§ 20.7 MOTIONS FOR RELIEF FROM THE AUTOMATIC STAY

When a motion for relief from the automatic stay (11 U.S.C. § 362) or the co-debtor stay (11 U.S.C. § 1201) is filed, it should be reviewed to ensure that the creditor demonstrates entitlement to such relief. Responses to motions for relief from stay must be timely filed. A secured creditor is entitled to relief from the automatic stay: (1) for cause; and (2) if there is no equity in the collateral, and the collateral is not necessary for an effective reorganization.

Collateral is not necessary for an effective reorganization if the debtor is unable to show that the collateral is essential to the reorganization and that an effective reorganization is realistically possible. *In re Ahlers*, 794 F.2d 388, 397–98 (8th Cir. 1986), *rev'd on other grounds*, 485 U.S. 197 (1988) (implying in dicta that the "necessary for an effective reorganization" language in section 362(d)(2)(B) requires a debtor to "not only show that the property in question is essential to the reorganization plan, but also that an effective reorganization is realistically possible.").

§ 20.8 MOTIONS FOR USE OF CASH COLLATERAL

A lack of credit financing for a debtor's farming operation is often the cause for denial of chapter 12 plans and dismissed chapter 12 cases. Because time is often of the essence in chapter 12 cases, motions for use of cash collateral to finance a debtor's farming operation should be filed as quickly as possible after the bankruptcy case is filed. The use of cash collateral requires the consent of the creditor that holds an interest in the cash collateral or court approval, after notice and a hearing. 11 U.S.C. § 363(c)(2). The creditor holding an interest in cash collateral may oppose the request for use of cash collateral or request adequate protection under 11 U.S.C. § 363(e). Generally, requests for use of cash collateral to finance the operations should be limited in time to end upon the expected date of confirmation of the plan because the plan will encompass the terms for any continued use of cash collateral beyond the date of confirmation of the plan and the terms for repayment of the debts securing such collateral.

A. Motion Requirements

Motions for use of cash collateral are limited to five pages and must contain a statement of the relief requested that lists all material provisions including:

(i) the name of each entity with an interest in the cash collateral;

(ii) the purposes for the use of the cash collateral;

(iii) the material terms, including duration, of the use of the cash collateral; and

(iv) any liens, cash payments, or other adequate protection that will be provided to each entity with an interest in the cash collateral or, if no additional adequate protection is proposed, an explanation of why each entity's interest is adequately protected.

FED. R. BANKR. P. 4001(b)(1)(B). In addition, the following statements must be attached to each motion for use of cash collateral:

1) the debtor's calculation of the amount of debt secured by the collateral;

2) the debtor's description of the collateral and estimate of the collateral's value on the date of the filing of the petition and at the beginning of the period of time for which the debtor currently seeks authorization to use cash collateral;

3) the debtor's description of the collateral and estimate of the collateral's value at the end of the period of time for which the debtor currently seeks authorization to use cash collateral; and

4) the debtor's cash flow projections.

MINN. BANKR. L.R. 4001-2(a). A court may not commence a final hearing on a cash collateral motion earlier than 14 days after service of the motion. FED. R. BANKR. P. 4001(b)(2).

B. Expedited Hearing

If immediate and irreparable harm threatens the estate, a debtor may request an expedited, preliminary hearing prior to the final hearing. The debtor will need to demonstrate: (1) why the harm to occur is immediate and irreparable; and (2) the extent of cash collateral required to prevent that harm. If the use of cash collateral is allowed by the court, it will only be on a preliminary basis and a final hearing will be held a minimum of 14 days after service of the motion.

C. Adequate Protection

Debtors have the burden of establishing that adequate protection exists for a secured party. *In re Berens*, 41 B.R. 524, 526 (Bankr. D. Minn. 1984). Objections to motions for use of cash collateral are often premised on a claimed lack of adequate protection. In chapter 12, proof of an equity cushion or the offering of a replacement lien are common methods by which a debtor establishes that adequate protection exists. Of note, section 1205 (rather than section 361) governs adequate protection in chapter 12 cases. *See* 11 U.S.C. § 1205(a).

1. Equity Cushion

An equity cushion may be sufficient to justify the use of cash collateral and establish adequate protection of the secured party. *See* 11 U.S.C. § 1205(b)(1) (requiring payments to a secured party if there is a decrease in value of such entity's interest in the property). As explained by the Ninth Circuit in *In re Mellor*, 734 F.2d 1396, 1400 (9th Cir. 1984), "the existence of an equity cushion as a method of protection … is the classic form of protection for a secured debt" and can provide adequate protection "standing alone." As in other areas of the chapter 12 confirmation process, a valid basis for valuation of assets is important. While a debtor's estimate of value may be acceptable in certain cases, a court may give little weight to an opinion if not based upon sufficient facts. *See In re Plummer*, 20 Mont. B.R. 468, 478 (Bankr. D. Mont. 2003). The percentage of the equity cushion can be calculated by subtracting the secured claim amount from the collateral value and dividing that result by the secured claim amount. Some courts have found equity cushion percentages as low as 15 percent sufficient for use of cash collateral. *See*, *e.g.*, *In re VZ Ranch*, 3 Mont. B.R. 82, 92–94 (Bankr. D. Mont. 1986). However, the facts of each case will determine whether an equity cushion percentage is sufficient to adequately protect a secured claimant's interest. *See In re Tucker*, 5 B.R. 180, 183 (Bankr. S.D.N.Y. 1980). Current and forecast market conditions, erosion by accruing interest, depreciation, and other factors will be considered by the court. *See In re Wilson*, 378 B.R. 862, 890 (Bankr. D. Mont. 2007).

2. Replacement Liens

Another common form of adequate protection used in chapter 12 is a replacement lien granted to a secured creditor whose collateral is to be sold under a proposed cash collateral motion. *See* 11 U.S.C. § 1205(b)(2). Generally, courts may grant liens in like-kind property, such as crops or livestock. *Berens*, 41 B.R. 524. *Contra In re Serbus*, 48 B.R. 5, 9 (Bankr. Minn. 1984) ("a lien in future crops is not in and of itself adequate protection…. Such a lien is too speculative to constitute a sound replacement security."). Cash flow projections are vital, as the court will take into consideration past net income figures from the operation, the margin of error in normal crop years, and risks such as bad weather, disease, and lower crop prices. *See Berens*, 41 B.R. at 527. In a notable case on the subject of replacement liens, the Eighth Circuit rejected a debtor's plan that sought to sell cattle (which served as loan collateral) use the proceeds for operating expenses, and grant a lien to the secured creditor in the debtor's real property. *In re Hanna*, 912 F.2d 945 (8th Cir. 1990). The court disallowed this lien replacement even though the lender was oversecured by a greater amount with the real estate lien than the livestock lien. *Id*. at 952. However, the court noted that the lien retention requirements of 11 U.S.C. § 1225(a)(5)(B)(i) can be interpreted to allow a farmer to sell inventory items (cattle in this case) so long as the creditor retains a lien on the herd and the value of the herd is maintained at a level sufficient to ensure that the creditor will recover the balance remaining on its claim in the event the debtor defaults on plan payments. *Id*. at 950–51.

3. Reasonable Rent

A third form of adequate protection in chapter 12 is payment for the use of farmland at a reasonable rental rate that is customary in the community where the property is located. *See* 11 U.S.C. § 1205(b)(3). Under this form of adequate protection unique to chapter 12 cases, the debtor need only protect the value of the property and not the value of the creditors' interest in property. "Put differently, if a creditor's collateral is real estate, the Chapter 12 debtor will in no event need to provide the creditor with more than the fair rental value of the land" to establish adequate protection per se. *In re Kocher*, 78 B.R. 844, 850 (Bankr. S.D. Ohio 1987).

§ 20.9 ASSUMING AND REJECTING LEASES

The debtor in possession, subject to the court's approval, may assume or reject an executory contract or unexpired lease of the debtor. 11 U.S.C. § 365(a); Fed. R. Bankr. P. 6006. A debtor in possession may not assume or assign an executory contract or lease of nonresidential real property that has been terminated under non-bankruptcy law prior to the order for relief. 11 U.S.C. § 365(c)(3).

If a debtor intends to reject a lease, such action should be taken promptly after filing. 11 U.S.C. § 365(d)(3) provides administrative expense status to post-petition, pre-rejection claims under leases of non-residential real property. *In re Burival*, 406 B.R. 548, 555 (B.A.P. 8th Cir. 2009), *aff'd*, 613 F.3d 810, 812–13 (8th Cir. 2010). Section 365(d)(3) excludes post-petition, pre-rejection obligations under leases of non-residential real property from the cost-benefit analysis used under 11 U.S.C. § 503(b)(1) to determine if an expense is an actual necessary cost or expense of preserving the debtor's bankruptcy estate and instead guarantees payment of post-petition, pre-rejection obligations regardless of any benefit to the debtor or its estate. *Id*. In other words, if a rent payment comes due post-petition and prior to rejection of a lease, the landlord will have a claim entitled to priority payment status as an administrative expense which must be paid in full. *See also In re Sky Ventures, LLC*, 523 B.R. 163 (Bankr. D. Minn. 2014). If a confirmed plan fails to address a non-residential real property lease, the lease is deemed rejected as of the date of the entry of an order confirming a plan. *See* 11 U.S.C. § 365(d)(4)(A)(i).

If a debtor intends to assume a lease, such action may be taken pursuant to a confirmed chapter 12 plan. *See* 11 U.S.C. § 365(g)(1). However, if a non-residential lease for real property is not assumed by motion under section 365(a) and a plan is not confirmed within 120 days of the order for relief, the lease is deemed rejected and the property must be surrendered immediately to the lessor. *See* 11 U.S.C. § 365(d)(4)(A)(i). If a debtor intends to assume a lease that is in default, a debtor will be required to: (1) cure the default or provide adequate assurances that the default will be promptly cured; (2) compensate or provide adequate assurances that the debtor will promptly compensate for actual pecuniary loss resulting from the default; and (3) provide adequate assurance of future performance. 11 U.S.C. § 365(b)(1).

PRACTICE TIP

If a debtor intends to assume a non-residential lease for real property through a plan provision, an attorney should be mindful of the 120-day automatic rejection provision. A debtor has 90 days from the order for relief to file a plan and another 45 days to conclude confirmation, so the first attempt at plan confirmation could conceivably take place up to 135 days from filing. In addition, courts can, and often do, continue confirmation hearings well beyond the 45-day mark "for cause" under 11 U.S.C. § 1224, so it is highly likely that a plan will not be confirmed within 120 days of filing. A 90-day extension of the 120-day period may be sought pursuant to 11 U.S.C. § 365(d)(4)(B) but only prior to the expiration of the 120-day period. Note that even if the intent is to assume, but the 120-day period lapses and a lessor demands and receives turnover of the real property, any post-petition, pre-rejection claims under leases of nonresidential real property will receive administrative expense status and must be paid in full in a debtor's plan. *See In re Burival*, 406 B.R. 548, 555 (B.A.P. 8th Cir. 2009), *aff'd*, 613 F.3d 810, 812–13 (8th Cir. 2010).

§ 20.10 MOTIONS TO SELL

Pursuant to 11 U.S.C. § 363(f), property may be sold free and clear of an entity's interest *only if* applicable nonbankruptcy law allows it, the entity holding the interest consents, the sale price will be greater than all liens on the property, the interest is in bona fide dispute, or the entity holding the interest could be compelled to accept money satisfaction in a legal or equitable action. However, a chapter 12 debtor may sell (after notice and a hearing) farmland and farm equipment free and clear of any interest without satisfying the requirements of 11 U.S.C. § 363(f), except that the proceeds of the sale are subject to that interest. *See* 11 U.S.C. § 1206.

§ 20.11 OBTAINING CREDIT

In some circumstances, a chapter 12 debtor is unable to obtain unsecured credit to finance a farm operation, in that case the Bankruptcy Code provides methods that may be used to induce a creditor to provide financing. Section 364(c) states that:

> If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, *after notice and a hearing*, may authorize the obtaining of credit or the incurring of debt—
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.

11 U.S.C. § 364(c) (emphasis added). Courts have also indicated that court approval is required to grant security interests in bankruptcy estate property. As stated by the Bankruptcy Court for the Eastern District of Michigan:

> If creditors are unwilling to extend unsecured credit to a debtor in possession, further inducements are offered, *with court approval after notice and a hearing*, including super priority administrative expenses under 11 U.S.C. § 364(c)(1); secured liens on unencumbered property pursuant to 11 U.S.C. § 364(c)(2); junior liens on encumbered property in accordance with 11 U.S.C. § 364(c)(3), or senior or equal liens pursuant to 11 U.S.C. § 364(d).

In re Mayco Plastics, Inc., 379 B.R. 691, 706 (Bankr. E.D. Mich. 2008) (emphasis added).

§ 20.12 CONFIRMATION OF THE PLAN

A. Confirmation Hearing Date

The confirmation hearing must be concluded not later than 45 days after filing of the plan, except for cause. 11 U.S.C. § 1224. The 1986 house conference report on this section indicates that this exception of extension for cause should be used sparingly, "in order to facilitate the proper operation of chapter 12—which proper operation depends on prompt action." H.R. Rep. No. 99-958, 99th Cong., 2d Sess., at 50 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5251. While a motion to extend the time for filing a plan is a proper motion, the legislative history gives no guidelines as to when such a motion is proper. The court in *In re Bentson*, 74 B.R. 56, 58 (Bankr. D. Minn. 1987) set forth several criteria for deciding whether to grant an extension, noting that "[a] debtor's cash flow projections for the initial plan must also have made a prima facie showing that reorganization is possible. Chapter 12 will not be used as a delay technique."

B. Burden

As with eligibility, the chapter 12 debtor bears the burden of proving that the proposed plan satisfies all of the criteria for confirmation set out in 11 U.S.C. § 1225(a). *See Haden v. Pelofsky*, 212 F.3d 466 (8th Cir. 1999).

C. Confirmation Criteria

Confirmation is mandatory if all statutory requirements are met under 11 U.S.C. § 1225(a). These criteria are:

- the plan complies with the provisions of the Bankruptcy Code;
- all fees and charges are paid before confirmation;
- the plan is "proposed in good faith and not by any means forbidden by law";
- the "best interests" test is met;
- each secured claim is properly treated;
- the plan is feasible;
- all domestic support obligations first coming due post-petition have been paid in full; and
- the plan satisfies the "disposable income" test for the length of the plan approved by the court (if an objection has been filed).

11 U.S.C. § 1225(a).

1. Good Faith

If no objections are timely filed, the court may determine that the plan has been "proposed in good faith and not by any means forbidden by law without receiving evidence on such issues." Fed. R. Bankr. P. 3015(f). For a discussion of what constitutes "good faith," see *infra* Chapter 21, Chapter 13 – Individuals with Regular Income. The conversion of collateral by the debtor and/or the abuse and delay of the bankruptcy process by the debtor constitute a plan not proposed in good faith. *In re Barger*, 233 B.R. 80 (B.A.P. 8th Cir. 1999).

2. "Best Interests" Test

Under 11 U.S.C. § 1225(a)(4), a debtor must be able to prove at the confirmation hearing that the amount to be distributed under the plan for each allowed unsecured claim is not less than the amount that would be paid on such claim if the debtor were liquidated under chapter 7. *See also In re Przybylski*, 340 B.R. 624 (Bankr. E.D. Wis. 2006); U.S. Trustee Handbook For Chapter 12 Trustees, ch. 3 at 3–17 (July 1, 2013) ("The standing trustee must review a liquidation analysis of real and personal property prior to confirmation or modification of a plan."). An attorney for a chapter 12 debtor must give consideration to the early preparation of an accurate analysis of the liquidation value of all of the property of the debtor's estate. This information should be prepared to be offered as an exhibit at the confirmation hearing, or the court may not confirm the debtor's plan. The liquidation analysis should be attached as an exhibit to the debtor's plan.

3. Proper Treatment of Secured Claims

A debtor's plan must provide that: (1) the holder of the claim accepts the plan; (2) the holder of the claim retains the lien securing the claim and is paid present value of the allowed claims; or (3) the property will be surrendered. This provision does not preclude a debtor from cramming down an undersecured creditor's lien to the value of the collateral under 11 U.S.C. § 1222(b)(2). *Harmon v. United States through Farmers Home Admin.*, 101 F.3d 574 (8th Cir. 1996). For fluctuating collateral inventory, the plan must provide that the value of the collateral be maintained at sufficient levels. *In re Hanna*, 912 F.2d 945 (8th Cir. 1990) (livestock lender retains its lien on the herd, rather than on the particular animals that comprise the herd; therefore, the plan has to provide that value of the herd would be maintained at a sufficient level).

4. Plan Feasibility

A debtor must demonstrate that the debtor will be able to make all payments called for under the proposed plan. The debtor must attach cash flow statements projecting income and expenses during the life of the plan to demonstrate feasibility. In the absence of such cash flow statements, feasibility under 11 U.S.C. § 1225(a)(6) is more difficult to demonstrate, and the chapter 12 trustee may file an objection to the confirmation of the plan until such cash flow projections are provided.

Success need not be guaranteed to establish feasibility. 5 Alan N. Resnick & Henry J. Sommer, Collier on Bankruptcy ¶ 1129.02 (16th ed. 2010). Courts are known to "grant debtors the [sic] every reasonable benefit of the doubt in matters concerning plan feasibility in furtherance of the rehabilitative policies underlying the Code." *See*, *e.g.*, *In re Tofsrud*, 230 B.R. 862, 872–73 (Bankr. D. N.D. 1999). However, courts will not blindly confirm a plan that will not cash flow. *See In re Dittmer*, 82 B.R. 1019, 1022 (Bankr. D. N.D. 1988). "In determining whether [a plan] is feasible, the bankruptcy court has an obligation to scrutinize the plan carefully to determine whether it offers a reasonable prospect of success and is workable." *In re Monnier Bros.*, 755 F.2d 1336, 1341 (8th Cir. 1985) (citing *United Props., Inc. v. Emporium Dep't Stores, Inc.*, 379 F.2d 55, 64 (8th Cir. 1967)). Funding a plan through CRP payments has been held not to be feasible when the federal government held the right of setoff on the payments.

In re Krause, 261 B.R. 218 (B.A.P. 8th Cir. 2001). As also stated by the Ninth Circuit Court of Appeals, "[w]hile economic certainty is not a necessary element of feasibility, courts cannot confirm plans that are purely "visionary." *In the Matter of Pizza of Haw., Inc.*, 761 F.2d 1374, 1382 (9th Cir. 1985). For elderly debtors, creditors may be able to lodge successful objections to the feasibility of successful completion of a plan based on a debtor's age, where restructured loans terms may extend 30 years into the future. *See In the Matter of Rose*, 135 B.R. 603 (Bankr. N.D. Ind. 1991); *In re Howard*, 212 B.R. 864, 878 (Bankr. E.D. Tenn. 1997). Courts also consider past performance, market risk, and current economic conditions in determining whether a plan is feasible. *In re Snider*, 83 B.R. 1003 (Bankr. N.D. Ind. 1988).

5. Disposable Income

After the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), chapter 12 and chapter 13 differ over what constitutes disposable income. Under chapter 12, "disposable income" means income that is received by the debtor and is not reasonably necessary to be expended for: (1) the maintenance and support of the debtor for a dependent of the debtor; (2) domestic support obligations first becoming payable post-petition; or (3) the payment of business expenses. 11 U.S.C. § 1225(b)(2). The requirements set forth in 11 U.S.C. § 707(b)(2) and the standards used to evaluate whether those requirements have been met are not mentioned in 11 U.S.C. § 1225 and thus are inapplicable to chapter 12. Whether the debtor commits all of his expected disposable income to the plan is a factual inquiry. *In re Broken Bow Ranch, Inc.*, 33 F.3d 1005 (8th Cir. 1994). Because of the variability of income for farmers in chapter 12, the trustee prefers a pledge of disposable income and a yearly calculation of disposable income from the farming operation.

D. The Effect of Plan Confirmation

Confirmation binds the debtor, each creditor, each equity security holder, and each general partner in the debtor to the provisions contained within the plan, whether or not each individual or entity is provided for in the plan. 11 U.S.C. § 1227; *First Nat'l Bank v. Allen*, 118 F.3d 1289 (8th Cir. 1997) (claim holders are bound by terms of plan); *In re Varat Enters., Inc.*, 81 F.3d 1310, 1317 (4th Cir. 1996) ("[A] confirmed plan of reorganization acts like a contract that is binding on all parties, debtor and creditors alike…. [A] party in interest's failure to object to a claim made on a debtor's assets prior to confirmation of the debtor's reorganization plan may operate as a waiver, barring the party from asserting the objection later.").

E. The Effect of Plan Confirmation on Property of the Estate

Property will automatically vest in the debtor at plan confirmation, absent plan provisions or the order confirming the plan directing otherwise. 11 U.S.C. § 1227(b). At first blush, this provision seems at odds with 11 U.S.C. § 1207, which provides that property of the estate includes property and earnings acquired post-petition. In the chapter 13 context, the Eighth Circuit settled this issue when it concluded that the bankruptcy estate continued to exist after confirmation, even if it holds no property. *Sec. Bank of Marshalltown, Iowa v. Neiman*, 1 F.3d 687, 690 (8th Cir. 1993). An important practical effect of the case is that the automatic stay does continue to prevent post-petition creditors from garnishing a debtor's earnings or collecting against other assets of the bankruptcy estate. As the chapter 13 provisions are almost identical to those in chapter 12, it is logical that courts within the Eighth Circuit would apply the *Nieman* logic to chapter 12 cases.

Estate property vests in the debtor free and clear of any liens, absent plan provisions or the order confirming the plan directing otherwise. 11 U.S.C. § 1227(c). As discussed by the Eighth Circuit in *Harmon v. United States through Farmers Home Administration*, 101 F.3d 574, 581–82 (8th Cir. 1996), where a debtor's plan does not expressly preserve a secured creditor's lien, the confirmation of the plan may act to extinguish the lien, provided that: (1) the lienholder participated in the debtor's bankruptcy case by filing a proof of claim; and (2) the property was either "dealt with" or "provided for" by the plan. *See also In re Siemers*, 205 B.R. 583 (Bankr. D. Minn. 1997).

F. Post-Confirmation

1. Automatic Stay

Absent specific language in the plan, the automatic and co-debtor stays remain in place during the term of the confirmed plan. However, the failure to comply with the chapter 12 plan has been held sufficient cause to grant stay relief. *Reinbold v. Dewey Cnty. Bank*, 942 F.2d 1304 (8th Cir. 1991).

PRACTICE TIP

Parties frequently agree in the confirmed plan that the secured creditor may enforce its rights and remedies under its loan agreement in the event of default under the terms of the confirmed plan, not requiring the secured creditor to bring a separate motion for relief from the automatic stay post-confirmation. A short notice of default and right to cure provision is also frequently negotiated.

2. Unexpected Income and Windfalls to the Debtor

As in other chapters, the debtor's pre-petition property is property of the estate, subject to the exceptions found in 11 U.S.C. § 541(b). Property acquired by the debtor post-petition and before the case is closed or converted to a chapter 7 is also property of the estate, including earnings from services performed by the debtor post-petition. 11 U.S.C. § 1207. As in chapter 13, the chapter 12 trustee considers windfalls (gambling winnings, lottery winnings, inheritances, life insurance proceeds, etc.) received during the bankruptcy to be both bankruptcy estate property pursuant to 11 U.S.C. § 1207 and disposable income pursuant to 11 U.S.C. § 1225(b)(2). As the provisions of section 1207 are nearly identical to those of section 1306 (estate property in chapter 13), the case law interpreting section 1306 is relevant in the chapter 12 context. *See Harris v. Viegelahn*, 135 S. Ct. 1829, 1835 (2015) ("…the Chapter 13 estate from which creditors may be paid includes both the debtor's property at the time of his bankruptcy petition, and any wages and property acquired after filing."); *see also Carroll v. Logan*, 735 F.3d 147 (4th Cir. 2013); *Dale v. Maney*, 505 B.R. 8 (B.A.P. 9th Cir. 2014); *In re Hart*, 151 B.R. 84 (Bankr. N.D. Tex. 1993). The trustee will likely seek the turnover of windfalls for the benefit of unsecured creditors. The assertion that an asset would be exempt will not protect such assets from being considered disposable income for purposes of increasing the return to the creditors of a chapter 13 debtor. *See In re Taylor*, 212 F.3d 395, 397 (8th Cir. 2000) ("The fact that [income] is exempt from the reach of creditors does not preclude a bankruptcy court from finding that [income] is also disposable income for purposes of chapter 13."); *see also In re Sohn*, 300 B.R. 332 (Bankr. D. Minn. 2003).

3. Modification of the Plan

Pursuant to section 1229(a), at any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, on request of the debtor, the trustee, or the holder of an allowed unsecured claim, to:

> (1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
>
> (2) extend or reduce the time for such payments; or
>
> (3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan.

The debtor has the burden of proof when seeking to modify a confirmed chapter 12 plan. *In re Daniels*, 531 B.R. 134, 141. (Bankr. W.D. La. 2015).

4. Death of the Debtor

Federal Rule of Bankruptcy Procedure 1016 provides that:

> If a reorganization, family farmer's debt adjustment, or individual's debt adjustment case is pending under chapter 11, chapter 12, or chapter 13, the case may be dismissed; or if further administration is possible and in the best interest of the parties, the case may proceed and be concluded in the same manner, so far as possible, as though the death or incompetency had not occurred.

However, the death of the debtor will result in dismissal of the case unless the chapter 12 trustee agrees to become the debtor in possession. *In re Erickson*, 183 B.R. 189 (Bankr. D. Minn. 1995).

§ 20.13 SPECIAL TAX PROVISIONS – ELIMINATION OF CAPITAL GAINS TAX

Prior to the BAPCPA, chapter 12 plans were required to provide for full payment in deferred cash payments of all priority claims, as defined by 11 U.S.C. § 507, in order to achieve confirmation, unless the claim holder agreed otherwise. *In re Dawes*, 382 B.R. 509, 512 (Bankr. D. Kan. 2008). Effective for all cases filed after April 20, 2005, chapter 12 plans are required to provide for full payment in deferred cash payments of all priority claims, as defined by 11 U.S.C. § 507, in order to achieve confirmation, unless the claims are owed to a governmental unit and arose as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation (i.e., capital gains), in which case the claim is treated as an unsecured claim that is not entitled to priority under section 507. 11 U.S.C. § 1222(a)(2). In other words, an otherwise priority capital gain tax only receives treatment as a dischargeable general unsecured claim.

Until October 26, 2017, this debtor-friendly treatment of otherwise priority capital gain taxes was limited to pre-petition sales of eligible assets due to the Supreme Court's decision in *Hall v. United States*, 132 S. Ct. 1882, 1885 (2012). According to the Court, a tax from the post-petition sale was not a section 507(a)(8) pre-petition tax or a section 507(a)(2) administrative expense, which would include any tax incurred by the estate, because no separate taxable estate is created in chapter 12. *See id*. (explaining that a chapter 12 estate cannot incur a tax, as 26 U.S.C. §§ 1398 and 1399 specify that a separate taxable estate is only created in those cases where an individual files under chapter 7 or chapter 11, and not in a chapter 12). As a result, post-petition capital gains taxes were incurred by the debtor and were not dischargeable as a general unsecured claim. Section 1232 was subsequently enacted in late 2017 to abrogate the Supreme Court's decision and provides in relevant part:

> Any unsecured claim of a governmental unit against the debtor or the estate that arises before the filing of the petition, or that arises after the filing of the petition and before the debtor's discharge

under section 1228, as a result of the sale, transfer, exchange, or other disposition of any property used in the debtor's farming operation:

(1) shall be treated as an unsecured claim arising before the date on which the petition is filed;

(2) shall not be entitled to priority under section 507;

(3) shall be provided for under a plan; and

(4) shall be discharged in accordance with section 1228.

11 U.S.C. § 1231(a). This provision allows a chapter 12 debtor to sell farm assets post-petition as a part of a reorganization effort and avoid the capital gain tax implications that would otherwise emerge from such sales. However, the capital gains are treated as dischargeable general unsecured claims for purposes of the plan only and would be eliminated only upon a debtor's completion of a chapter 12 plan and receipt of a discharge.

A. Defining "Farm Assets Used in Farming Operation" Under 11 U.S.C. § 1222(a)(2)

Although chapter 12 debtors are now entitled to favorable treatment of post-petition capital gains as dischargeable general unsecured claims, courts disagree as to whether all farm assets sold by a debtor will constitute an asset used in the debtor's farming operation for purposes of the favorable treatment under 11 U.S.C. §§ 1222(a)(2) and 1232(a). For instance, the U.S. Bankruptcy Court for the District of Kansas held that feeder cattle and crops are not "used in" a farming operation in the way that breeding stock, land, and equipment are used. *See In re Keith*, No. 10-12997, 2013 WL 3467315 (Bankr. D. Kan. Sept. 24, 2013). As a result, the tax incurred from the pre-petition sale of the feeder cattle and crops was a 507(a)(8) claim entitled to payment in full during the bankruptcy case. However, a divided Eighth Circuit in *Knudsen* determined that farm assets used in the farming operation include "capital assets under I.R.C. § 1231, other property that may receive favorable tax treatment…, and inventory items that would otherwise generate ordinary income under I.R.C. § 61" and held that slaughter hogs were assets used in a farming operation. *Knudsen v. I.R.S.*, 581 F.3d 696, 712 (8th Cir. 2009), *abrogated on other grounds by Hall v. United States*, 132 S. Ct. 1882 (2012). Those claims are instead treated as general unsecured claims, payable less than in full and dischargeable. *Id*.

PRACTICE TIP

The favorable treatment of capital gains taxes incurred from the sale of assets both pre- and post-petition should be considered prior to filing if the liquidation of assets is planned or anticipated. Farmers often use accelerated depreciation to defer tax liabilities and the sale of these assets post-petition could result in considerable capital gains. An analysis of whether the assets sold pre-petition are "used in a farming operation" is also important in determining whether the favorable treatment of capital gains taxes will apply.

§ 20.14 CONVERSION AND DISMISSAL

A. Conversion or Dismissal by a Debtor

1. Conversion to Chapter 7

A chapter 12 debtor may voluntarily convert a chapter 12 case to a chapter 7 case "at any time by filing a verified conversion adapted from Local Form 1019-1." MINN. BANKR. L.R. 1019-1(a). The conversion must be accompanied by the exhibits, attachments, schedules, statements, and lists appropriate for a chapter 7 case, including the statement of current income and expenditures and statement of intention. *Id*. Any waiver of the right to convert a chapter 12 case by the debtor is unenforceable. 11 U.S.C. § 1208(a).

2. Conversion to Chapter 11 or 13

"There is no provision in Chapter 12 allowing for the conversion of a case from Chapter 12 to either Chapter 11 or 13." HON. JOAN FEENEY ET AL., BANKRUPTCY LAW MANUAL, § 12:10 (5th ed. 2015). However, a split of authority exists regarding the ability of a debtor to convert a case to a chapter other than chapter 7. Some courts have allowed such conversions with permission of the bankruptcy courts if three criteria are met:

1. when the debtor has filed the chapter 12 case in good faith;
2. there is no prejudice to creditors; and
3. the conversion of the case would be equitable.

See In re Orr, 71 B.R. 639, 643 (Bankr. E.D.N.C. 1987) ("the court may in its discretion permit conversion to chapter 11 where the chapter 12 petition was filed in good faith, creditors will not be prejudiced by the conversion, and conversion would not be otherwise inequitable"). "Other courts, however, have denied conversions from Chapter 12 to Chapter 11 under the premise that Congress did not authorize them." *In re Colón*, No. 16-0060, 2016 Bankr. LEXIS 2344, at *11 (Bankr. D. P.R., June 21, 2016); *see also In re Christy*, 80 B.R. 361, 364 (Bankr. E.D. Va. 1987).

3. Voluntary Dismissal

According to section 1208(b), if a case has not been converted under 11 U.S.C. § 706 or 1112, a debtor may request dismissal of the case at any time and any waiver of the right to dismiss a chapter 12 case by the debtor is unenforceable. However, pursuant to the Eighth Circuit's decision in *Graven*, a chapter 12 debtor cannot utilize section 1208(b) as an escape hatch if a fraud has been committed in connection with the case and a party in interest seeks conversion. *See In re Graven*, 936 F.2d 378 (8th Cir. 1991). In that case, the Eighth Circuit determined that section 1208(b) did not afford a chapter 12 debtor an unlimited right to voluntary dismissal, stating that "[w]e conclude that the broad purpose of the bankruptcy code, including Chapter 12, is best served by interpreting section 1208(d) to allow a court to convert a case to Chapter 7 upon a showing of fraud even though the debtor has moved for dismissal under subsection (b)." *Id.* at 385.

B. Conversion or Dismissal on Request of the Trustee, Creditors, and Other Parties in Interest

1. Dismissal

The chapter 12 trustee, a creditor, or any other party in interest may make a motion to dismiss the case "for cause." 11 U.S.C. § 1208(c). "Cause" includes:

> (1) unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors;
>
> (2) nonpayment of any fees and charges required under chapter 123 of [U.S.C.] title 28;
>
> (3) failure to file a plan timely under [11 U.S.C. § 1221];
>
> (4) failure to commence making timely payments required by a confirmed plan;
>
> (5) denial of confirmation of a plan under [11 U.S.C. § 1225] … and denial of a request made for additional time for filing another plan or a modification of a plan;
>
> (6) material default by the debtor with respect to a term of a confirmed plan;
>
> (7) revocation of the order of confirmation under [11 U.S.C. § 1230] … and denial of confirmation of a modified plan under [11 U.S.C. § 1229] … ;
>
> (8) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan;
>
> (9) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation; and
>
> (10) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

11 U.S.C. § 1208(c).

2. Conversion to Chapter 7 for Fraud

A case may be involuntarily converted to chapter 7 on request of a party in interest upon a showing that the debtor has committed fraud in connection with the case. 11 U.S.C. § 1208(d) is unique to the context of chapter 12 bankruptcy cases and provides the court with the authority to consider the debtor's conduct and actions within the case, disrespect of the bankruptcy process, and candor to the court. *See In re Zurface*, 95 B.R. 527, 539 (Bankr. S.D. Ohio 1989) (citing the legislative history to support the proposition that Congress included this provision to foster an environment of good faith and honest dealing by debtor throughout the pendency of the bankruptcy case). According to one court, although Congress sought to ease the burdens of family farmers who found bankruptcy to be their only option, it "also intended to prevent abuse of the bankruptcy system and to ensure farm creditors [would] receive fair debt repayment treatment." *In re Pianowski*, 92 B.R. 225, 232 (Bankr. W.D. Mich. 1988) (quoting H.R. Rep. No. 99-958, 99th Cong., 2d Sess., at 48 (1986)).

§ 20.15 DISCHARGE

The debtor will receive a discharge after completing all payments under the chapter 12 plan as long as the debtor certifies (if applicable) that all domestic support obligations that came due before making the certification have been paid. 11 U.S.C. § 1228(a). The discharge has the effect of releasing the debtor from all debts provided for by the plan allowed under 11 U.S.C. § 503 or disallowed under 11 U.S.C. § 502, with limited exceptions. *Id.* Those creditors who were provided for in full or in part under the plan may no longer initiate or continue any legal or other action against the debtor to collect the discharged obligations. 11 U.S.C. § 1228(c). However, as with other chapters, certain debts may be exempted from discharge under 11 U.S.C. § 523. The court may grant a "hardship discharge" to a chapter 12 debtor even though the debtor has failed to complete plan payments. 11 U.S.C. § 1228(b). Generally, a hardship discharge is available only to a debtor whose failure to complete plan payments is through no fault of the debtor and due to circumstances beyond the debtor's control. Creditors must have received at least as much as they would have received in a chapter 7 liquidation case, and the debtor must be unable to modify the plan. For example, injury or illness that precludes employment sufficient to fund even a modified plan may serve as the basis for a hardship discharge. The hardship discharge does not apply to any debts that are non-dischargeable in a chapter 7 case. 11 U.S.C. § 523.

Text continued on page 20-39.

APPENDIX A –
SUMMARY OF OPERATIONS FOR CHAPTER 12 CASE

UST-SD
Enclosure No. 1

CHAPTER 12 CASE

SUMMARY OF OPERATIONS – FAMILY FARMER
(This report must be filed with the Chapter 12 Trustee
5 days before the first meeting of creditors)

NAME OF DEBTOR(S): ______________________________

CASE NO: ______________________________

I. CURRENT NUMBER OF ACRES

Owned: ______________________________

Leased: (List by Parcel)	Amount or % of rent received by debtor(s)
______________________________	______________________________
______________________________	______________________________
______________________________	______________________________

Total owned and leased by
debtor(s) from others: ______________________________

Total leased to others: ______________________________

Tillable acreage: ______________________________

Set aside acreage: ______________________________

II. CURRENT LIVESTOCK

Kind	No.	Weight	Market Value
Hogs	________	__________	__________
Feeder Pigs	________	__________	__________
Sows	________	__________	__________
Boars	________	__________	__________
Calves	________	__________	__________
Stock Cows	________	__________	__________
Steers	________	__________	__________
Heifers	________	__________	__________
Bulls	________	__________	__________
Dairy Cows	________	__________	__________
Lambs	________	__________	__________
Ewes	________	__________	__________
Rams	________	__________	__________
Foals	________	__________	__________
Mares	________	__________	__________
Stallions	________	__________	__________
Chickens	________	__________	__________
Turkeys	________	__________	__________

III. PRIOR YEAR'S OPERATION

A. Livestock (list by kind)

Kind	No.	Weight Per Animal	Amount Kept For Farm Use	Amount Sold	Sales Prices	Total Dollar Sales

B. Crops (list by kind)

Kind	No. of Acres Planted	Yield Per Acre	Amount Kept For Farm Use	Amount Sold	Sales Prices	Total Dollar Sales

C. Raw Products (e.g., wool, eggs, milk, fish)

Kind	Weight or Number	Amount Kept for Farm Use	Amount Sold	Sales Prices	Total Dollar Sales

D. Other Farm Enterprises (e.g., custom farming, custom feeding) — Total Amount Received____

E. Government Payments — Total Amount Received____

F. Summary of Prior Year's Operation

1. Total crop/livestock income ______________________________
2. Total raw products income ______________________________
3. Total other farm income ______________________________
4. Total government payments ______________________________
5. Non-farm income ______________________________
6. Total income ______________________________

G. Have you made an assignment of proceeds? (Yes/No)

If yes, which proceeds have you assigned and to whom have you assigned them

____

____

____

IV. THIS YEAR'S OPERATION (current year projections)

A. Livestock (list by kind)

Kind	No.	Weight Per Animal	Amount Kept For Farm Use	Amount Sold	Sales Prices	Total Dollar Sales

B. Crops (list by kind)

Kind	No. of Acres Planted	Yield Per Acre*	Amount Kept For Farm Use	Amount Sold	Sales Prices**	Total Dollar Sales

C. Raw Products (e.g., wool, eggs, milk, fish)

Kind	Weight or Number	Amount Kept for Farm Use	Amount Sold	Sales Prices	Total Dollar Sales

D. Other Farm Enterprises (e.g., custom farming, custom feeding) — Total Amount Received

E. Government Payments — Total Amount Received

*Assuming normal moisture and growing conditions.

** State your estimate of market price per unit or government support (loan) price if you are eligible for government support program.

F. Summary of Projected Year's Income

1. Total crop/livestock income ______________________________

2. Total raw products income ______________________________

3. Total other farm income ______________________________

4. Total government payments ______________________________

5. Non-farm income ______________________________

6. Total income ______________________________

G. Estimated Expenses for Current Year

Expenses	Amounts
Fuel	____________________
Seed	____________________
Feed	____________________
Fertilizer	____________________
Herbicides, Pesticides, or other Chemicals	____________________
Equipment Rental	____________________
Electric and Phone Bills	____________________
Repairs	____________________
Crop Insurance	____________________
Other Insurance	____________________
Real Estate Taxes	____________________
Cash Rent	____________________
Hired Labor	____________________
Machine Hire	____________________
Drying	____________________
Other	____________________
	____________________
	____________________
	____________________

Projected Total Operating Expenses____________________

Projected Family Living Expenses _____________________

Projected Total Expenses _____________________________

H. Profit of Loss

Total Income (IV F 6) ___________________

Total Expenses (IV G) ____________________

Profit/Loss ______________________________
(subtract total expenses from total income)

I. Estimated Crop Expenses Breakdown:

	Corn Cost per Acre	Soybeans Cost per Acre	Oats Cost per Acre	Hay/Alfalfa Cost per Acre
Seed				
Nitrogen				
Phosphate				
Potash				
Lime				
Herbicide				
Insecticide				
Crop Insurance				
Other Insurance				
Real Estate Taxes				
Cash Rent				
Combining				
Hauling				
Drying				
Handling				
Hired Labor				
Fuel				
Other Machine Rental				
Miscellaneous				
TOTAL:				

J. Estimated Livestock Expenses Breakdown:

Costs	Swine Cost per_____	Beef Cost per_____	Sheep Cost per_____	Dairy Cost per _____
Corn				
Supplement				
Feed Additives				
Alfalfa-brome				
Corn Silage				
Haylage				
Salt				
Milk Replacer				
Minerals				
Veterinary				
Machinery and Equipment				
Electric				
Water				
Labor				
Marketing				
Miscellaneous				
Purchase Livestock				
Other				
TOTAL:				

NOTE: If your particular livestock operation does not fit these categories make appropriate adjustments.

If you have an operating loan for the current or proposed crop season, state amount $_____________ and name and address of lender ________________________

____

Text continued on page 20-49.

APPENDIX B –
MONTHLY CASH RECEIPTS AND DISBURSEMENTS STATEMENT

UST-SD
Enclosure No. 2

CHAPTER 12 MONTHLY REPORT

NAME OF DEBTOR(S): ____

CASE NO: ______________________________

For Month Ending ______________________________

MONTHLY CASH RECEIPTS AND DISBURSEMENTS

(Report on a cash basis, unless you keep financial records on an accrual basis)

I. CASH RECEIPTS

A. FARM INCOME

		MONTH	YEAR TO DATE
Grain Sales			
#bu.________	corn at $ __________	__________	__________
#bu.________	beans at $__________	__________	__________
#bu.________	oats at $ __________	__________	__________
#bu.________	milo at $ __________	__________	__________
#bu.________	wheat at $__________	__________	__________
Livestock Sales			
#hd________	feeder pigs at_____	__________	__________
#hd________ per/lb.	hogs at $__________		
#hd________ per/lb.	calves at $__________		
#hd________ per/lb	cattle at $__________		
#hd________	lambs at $__________		
Eggs ______________________		__________	__________
Poultry______________________		__________	__________
Milk ______________________		__________	__________
Other ______________________		__________	__________
______________________		__________	__________
______________________		__________	__________
______________________		__________	__________
Miscellaneous Farm Income			
Contract payments		__________	__________
Contract payments		__________	__________
Contract payments		__________	__________
Rent payment __________		__________	__________
Rent payment __________		__________	__________
Government payments		__________	__________
PIK and Roll proceeds		__________	__________

		MONTH	YEAR TO DATE
	Custom farming income	___	___
	Custom feeding payments	___	___
	Other farm income (please specify source)	___	___
	___		
	___		
	___		
	___		
	New loans (specify source)	___	___
	___		
	___		
B.	WAGES FROM OUTSIDE WORK		
	Husband	___	___
	Wife	___	___
C.	OTHER RECEIPTS		
	Social Security	___	___
	Other: ___	___	___
	___	___	___
	___	___	___
	Total Cash Receipts	___	___

II. EXPENSES PAID

A. HOUSEHOLD (Use more pages if necessary)

Payee	Dates	Amount	Purpose

B. FARM EXPENSES (Use more pages if necessary)

Payee	Dates	Amount	Purpose

TOTAL ______________________

C. TOTAL PAYMENTS MADE TO CHAPTER 12 TRUSTEE ____________________

TOTAL EXPENSES FOR MONTH ____________________

CASH PROFIT (LOSS) FOR MONTH ____________________
(TOTAL INCOME MINUS TOTAL EXPENSES) ____________________

OTHER NON-CASH LOSSES:

LOSS DUE TO CROP FAILURE OR
DAMAGE $__________________

LOSS DUE TO DEATH OR DIEASE
OF LIVESTOCK OR POULTRY
$____________________________

III. CASH RECONCILIATION:

Cash and Bank Accounts Balance at
Beginning of Month: $____________

Profit (or Loss) During Month $____________

Cash and Bank Account Balance at
End of Month $____________

IV. EXPENSES CHARGED BUT NOT PAID DURING MONTH (itemize):

Expense	Amount
	$

I CERTIFY UNDER PENALTY OF PERJURY THAT I HAVE READ THE FOREGOING STATEMENT, AND IT IS TRUE AND CORRECT TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

______________________________ ____
DATE DEBTOR(S) / OFFICER OF DEBTOR(S)

Text continued on page 20-55.

APPENDIX C –
TAX DEPOSIT STATEMENT

UST-SD
Enclosure No. 3

INSTRUCTIONS FOR TAX DEPOSIT STATEMENT

The tax accounts of Federal Withholding Tax, FICA and Sales Tax are all computed in the same manner.

The first month's statement following the filing of the petition the Beginning Tax Payable should be zero. After the first month's statement the beginning tax payable would be the prior month's ending tax payable.

Withheld or Accrued

The amount of taxes that were withheld or accrued during the month should be listed even if they were paid during the month.

Disbursements to Tax Account

Give the dollar amounts that were paid to the tax accounts. List the deposit receipt numbers (if possible send copies of the deposit slips) and/or the check numbers for each deposit.

Ending Tax Payable

This figure is derived by taking the beginning tax payable and adding to it the amounts withheld or accrued and subtracting the amounts paid.

If there are other tax accounts that your company is liable for, please include them on separate exhibits in the same manner as described above.

The Tax Deposit Statement must be signed by the debtor or an officer of the debtor company.

Evidence of Payment

When the taxes are paid, a copy of the documentation is to be provided to the Chapter 12 trustee.

TAX DEPOSIT STATEMENT

____, Debtor(s) in Possession

Month or Period Ending ________________________________, 20____

SUMMARY

FEDERAL WITHHOLDING TAX

Beginning Withholding Tax Payable ______________________________

Withheld or Accrued ______________________________

Disbursements to Tax Account ______________________________

Deposit Receipts
and/or check ________________
numbers ________________

Ending Withholding Tax Payable ______________________________

FICA WITHHOLDING TAX (include both employer and employee share)

Beginning FICA Tax Payable ______________________________

Withheld or Accrued ______________________________

Disbursements to Tax Account ______________________________

Deposit Receipts
and/or check ________________
numbers ________________

Ending FICA Tax Payable ______________________________

SALES TAX

Beginning Sales Tax Payable ____________________

New Sales Tax Payable ____________________

Disbursements to Tax Account ____________________

Deposit Receipts and/or check numbers ____________ ____________

Ending FICA Tax Payable ____________________

ATTACH COPIES OF ALL TAX DEPOSIT RECEIPTS TO THE MONTHLY TAX STATEMENT.

I CERTIFY UNDER PENALTY OF PERJURY THAT I HAVE READ THE FOREGOING STATEMENT, AND IT IS TRUE AND CORRECT TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

____
Debtor(s) or Officer of the Debtor(s)

Text continued on page 20-59.

APPENDIX D
DEBTOR IN POSSESSION BANK ACCOUNTS REPORTING FORM

UST-SD
Enclosure No. 4

CASE NAME: ________________________________ CASE NO.________________

BANK ACCOUNTING REPORTING FORM

(Must be submitted to United States Trustee within ten (10) days of receipt of this form and accompanying letter and immediately following established of any post-petition accounts of closing of any accounts.)

I/we certify that the following is a complete report of all bank accounts/investments owned by the debtor as of the date of the filing of debtor's petition, and established or closed by debtor (where applicable) post-petition:

DEPOSITORY INSTITUTION		ACCOUNT DESCRIPTION (i.e., Designate if payroll or tax account, etc.)	ACCOUNT NO.
NAME:	____________________________	______________	______________
ADDRESS:	____________________________	______________	______________
	____________________________		
PHONE:	____________________________	______________	______________
NAME:	____________________________	______________	______________
ADDRESS:	____________________________	______________	______________
	____________________________		
PHONE:	____________________________	______________	______________
NAME:	____________________________	______________	______________
ADDRESS:	____________________________	______________	______________
	____________________________		
PHONE:	____________________________	______________	______________
NAME:	____________________________	______________	______________
ADDRESS:	____________________________	______________	______________
	____________________________		
PHONE:	____________________________	______________	______________

I/we certify that all above-listed depository institutions have been notified of the Chapter 12 filing and where and when the petition was filed.

THE UNDERSIGNED DECLARES UNDER PENALTY OF PERJURY THAT THE INFORMATION CONTAINED IN THE FOREGOING REPORT IS TRUE, COMPLETE, AND ACCUREATE.

DATED THIS _______________ DAY OF ___________________________________, 20______.

SIGNATURE: ____
(Must be signed by individual debtor(s) or authorized representative if debtor is not an individual)

SESSION 402

Beyond Your Bankruptcy Reporter: The Top Ten Minnesota State Cases that Every Bankruptcy Attorney Should Know

Mychal A. Bruggeman
Tiede Grabarski, PLLC
White Bear Lake

Kenneth Edstrom
Sapientia Law Group, PLLC
Minneapolis

THE TEN (OR SO) MOST IMPORTANT

MINNESOTA STATE COURT CASES FOR BANKRUPTCY LAWYERS

Mychal A. Bruggeman, Esq. & Kenneth C. Edstrom, Esq.

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INTRODUCTION

We're bankruptcy lawyers, why do we care about state law cases and statutes?

In general, bankruptcy law looks to the applicable state law to decide property rights. *Butner v. United States*, 440 U.S. 48, 55 (1979).

Just as important, some of the common issues of the determination of rights under state law that arise in bankruptcy courts have not been decided by the Minnesota Supreme Court or the Minnesota Court of Appeals. A bankruptcy judge's opinion, or even the opinion of the Eighth Circuit is not binding on any state court deciding the same issue in state court under state law.

> Where a debtor chooses to exempt property pursuant to state statute, courts necessarily determine his or her eligibility thereunder by looking to state law." *In re Mueller*, 215 B.R. 1018, 1022 (B.A.P. 8th Cir. 1998) (citations omitted). In doing so, federal courts view decisions by the state's highest court as binding precedent. *Progressive N. Ins. Co. v. McDonough*, 608 F.3d 388, 390 (8th Cir. 2010). When the state's highest court has yet to opine, federal courts rely on opinions of the state's intermediary courts as persuasive authority to predict the state's highest court's outcome. *Id*. In Minnesota, "[t]he object of all interpretation and construction of laws is to ascertain and effectuate the intention of the legislature." MINN. STAT. § 645.16. Courts ascribe the plain and ordinary meaning to words to glean the intent of the legislature. *Premier Bank v. Becker Dev., LLC*, 785 N.W.2d 753 (Minn. 2010) (citing MINN. STAT. § 645.08). When the statute is unambiguous, the statute's plain meaning must apply. *Larson v. State*, 790 N.W.2d 700, 703 (Minn. 2010).

In re: Jacklitch, 2018 WL 3655380 at *1 (Minn. Bankr. (Ridgway) 2018)

So, it is important to know what the state law and state cases say which may affect which exemption scheme you choose or whether you need to or should file a bankruptcy case in the first place.

<u>NUMBER 10: *Enright v. Lehmann*</u>

Bankruptcy Relevancy: (1) What is Property of the Estate (Joint Accounts); (2) Wild-Card Exemption

In *Enright v. Lehmann*, 735 N.W.2d 326 (Minn. 2007), the Minnesota Supreme Court set forth rules regarding the ownership of joint bank accounts with respect to a garnishment proceeding.

In *Enright* a landlord obtained a judgment for rents due from a corporate tenant and individual principal. The landlord then garnished two joint accounts of Mr. Lehmann and his wife. The parties agreed that Mrs. Lehmann had contributed all the funds in the joint account. The creditor further offered no evidence that Mrs. Lehmann had intended for Mr. Lehmann to own the funds.

The prevailing rule at the time allowed a creditor to garnish any funds in a joint account, regardless of who contributed the funds, if either spouse had the power to withdraw the funds in the joint account. *Park Enterprises v. Trach*, 47 N.W.2d 194 (Minn. 1951). The Minnesota Supreme Court reversed that holding and established new rules for ownership in joint accounts. The Court held that the contributions drive the right to garnishment, and that a creditor cannot garnish the funds contributed by a non-debtor unless the creditor provides clear and convincing evidence that the depositor intended the funds to belong to the debtor.

A few years later the Supreme Court added an additional wrinkle. In *Savig v. First National Bank of Omaha*, 781 N.W.2d 335 (Minn. 2010), the Minnesota Supreme Court held that the burden of establishing the contributions in an account still rested with the account holders.

The Court held that the creditor could proceed with a garnishment without establishing the net contributions or establishing "a different intent." In reconciling various arguments and related statutory provisions, the Court concluded that "the account holders are in the best position to provide details concerning who contributed or withdrew funds from a joint account; they are in a better position to know relevant facts."

In bankruptcy, if the debtor has a joint account interest with a non-debtor, the rules of *Enright* and *Savig* should apply in determining what portion of the account may be property of the estate or exempt. The debtors have the burden to establish the net contributions in the account, and if they cannot establish a net contribution calculation, a trustee should be able to seize the entire account. Even if the debtors establish the net contributions, a trustee could still argue that the contributing party intended the funds to belong to the debtor.

Also, if the debtors argue that ownership varies from net contributions, an argument may exist that an avoidable transfer has occurred based on the timing of any change of ownership and nature of the deposited funds (i.e., exempt earnings versus other non-exempt deposits).

Related State Authorities Regarding Property Ownership

If married debtors jointly own an asset, then each debtor may claim an exemption in that asset. 11 U.S.C. § 522(m).

Courts and scholars differ on how property law, and therefore bankruptcy law, should treat property purchased by both spouses during the course of marriage, and therefore who can claim what as exempt property. Some property is more clearly owned by one party; for example, if one spouse is the sole titleholder of a vehicle, in Minnesota the courts have found that the car is owned by that titleholder based on Minnesota statutory law. *Am. Nat'l Gen. Ins. Co. v. Solum*, 641 N.W.2d 891 (Minn. 2002); *Auto-Owners Ins. Co. v. Forstrom*, 684 N.W.2d 494 (Minn. 2004.) But in Bankruptcy court that is not always true even for titled vehicles.

The "Although the car is titled in my name, I bought a car for my non-filing spouse/girlfriend/son and it really belongs to them" scenario is common. In Minnesota, can the other party argue that they have a constructive trust in the ownership of the car such that it really belongs to them even if the title doesn't say so? Under Minnesota law, to establish the right to a constructive trust, the Plaintiff must prove the Defendant obtained the property by fraud, by bad faith, or by other improper means. *Henderson v. Murray*, 108 Minn. 76, 121 N.W. 214, 216 (1909).

The constructive trust argument therefore doesn't get much traction in Bankruptcy or state court and has been regularly rejected in order to protect the ability of other unsecured creditors to recover in the bankruptcy case.

There are even more complex issues over who owns what where property is purchased from a common fund, or if one spouse has no income. For example, under prior law, if an individual put their earnings into a joint checking account, Minnesota law would presume that they intended to transmute the ownership of those funds from sole ownership to joint ownership with any other person named on the account. *Park Enters. v. Trach*, 47 N.W.2d 194, 195–98 (Minn. 1951). However, the Minnesota Supreme Court later reversed itself and held that no such presumption occurs. *Enright v. Lehmann*, 735 N.W.2d 326, 336 (Minn. 2007); *see also Smith v. State*, 389 N.W.2d 543, 545 (Minn. Ct. App. 1986) (explaining this lack of presumption is in keeping with the Minnesota Multi-Party Accounts Act).

The Minnesota Supreme Court agreed with previously decided bankruptcy court cases that the concept of jointly owned "marital property" is not a concept that can be used to determine the ownership of property outside of a divorce proceeding. *In re Estate of Barg*, 752 N.W.2d 52, 61-62 (Minn. 2008), *cert. denied sub nom. Vos v. Barg*, 129 S. Ct. 2859 (2009), (recognized in the *Carlson* case as well).

<u>NUMBER 9: *Kipp v. Sweno*</u>

Bankruptcy Relevancy: (1) What is Property of the Estate (Joint Property); (2) Homestead Exemption; (3) Sale of Co-Owner Interest Under § 363(h)

In *Kipp v. Sweno*, 683 N.W.2d 259 (Minn. 2004), the Minnesota Supreme Court held that a judgment creditor could not unilaterally sever a non-debtor's joint tenancy interest in a debtor's homestead through execution sale.

The case involved a creditor's attempt to collect upon a fraud judgment against a debtor by executing upon his homestead. The debtor's equity in his one-half interest in the homestead had a value of $309,900, which exceeded the $200,000 exemption applicable at the time. The judgment did not apply to the debtor's spouse who held the property in a joint tenancy with the judgment debtor.

The Court held that the creditor could not sever the joint tenancy to execute upon the property, effectively making the property entirely exempt from collection. Minnesota law only allows the severance of a joint tenancy through the consent of both tenants. A divorce is a typical instance. The Court rejected the idea that somehow the creditor could protect the non-debtor spouse's interest in such a sale through eventual payment of her share because it would eliminate her "possessory or occupancy interest, right of survivorship interest and remainder interest."

Prior to *Kipp*, the Eighth Circuit held that the IRS could not levy upon a delinquent taxpayer's homestead held in joint tenancy with a non-delinquent spouse. *O'Hagan v. United States*, 86 F.3d 776 (8th Cir. 1996).

The Court further held that a creditor could execute upon and sell a right of survivorship, but that the debtor could apply his homestead interest to the proceeds of any sale. The purchaser of the survivorship interest cannot record the purchase, as that would sever the joint tenancy. Since it is unlikely there is much value to a survivorship interest, *Kipp v. Sweno* potentially creates an expanded exemption in certain cases.

It is not clear whether the full protections of *Kipp v. Sweno* apply in a bankruptcy. In bankruptcy, § 363(h) permits a trustee to sell both a debtor and co-owner's interest under the following circumstances: (1) partition is impracticable; (2) the sale of an undivided interest would yield less than the sale of the property free and clear of the co-owner's interest; (3) benefit to the estate of the sale outweighs the harm to the co-owners; (4) property is not used for the business of electricity or gas.

By its plain terms, § 363(h) would not bar the trustee from selling Minnesota real estate subject to a joint tenancy under the terms of *Kipp v. Sweno*, but related caselaw suggests that it is likely the bankruptcy court would be reluctant to sever a non-debtor's joint tenancy. *In re Wolk*, 451 B.R. 468 (BAP 8th Cir. 2011) (denying trustee's request to sell residence held in tenancy-in-common because of hardship it would place on non-debtor spouse); *Cf. In re Johnson*, 207 B.R. 878 (Bankr. D. Minn. 1997) (stating that the spouse's homestead interest protects the property from the bankruptcy estate's claim).

NUMBER 8: *In re Emerson / Denzer v. Prendergast*

Bankruptcy Relevancy: Homestead Exemption (Owner and Occupancy Test)

In *In re Emerson*, 60 N.W. 450 (Minn. 1894), the Minnesota Supreme Court held that the ownership and occupancy requirement in the statute allowing exemption of a homestead does not require fee ownership.

In *Emerson*, a debtor operated a hotel under a five-year lease, which qualified as a lease for years. The debtor found himself in personal financial distress, and his creditors appointed a receiver over the debtor individually. The receiver took over operations of the hotel in the debtor's capacity as a tenant. While managing the hotel, the debtor occupied several rooms for his family as their residence. The receiver, standing in the shoes only of the debtor's general creditors and not as a receiver over the land specifically, sought to eject the debtor but the debtor claimed a homestead interest in the rooms.

The Supreme Court upheld the debtor's homestead claim and denied the receiver's attempt to remove him from the property. As a postscript, Emerson later attempted to also assert homestead rights as to the subsequent lessor of the hotel, but the Supreme Court held that the lessor could pursue its remedies under its right of re-entry clause for Emerson's failure in continuing to operate the property as a hotel. *Spalding Hotel Co. v. Emerson*, 72 N.W. 119 (Minn. 1897).

In *Denzer v. Prendergast*, 126 N.W.2d 440 (Minn. 1964), the Minnesota Supreme Court again confirmed that any legal relationship to the property will generally protect the property from the debtors' general creditors. In *Denzer*, the debtor held only a remainder interest in the property after his father died and his mother retained a life estate in the family farm. The debtor and his family, however, resided within the residence on the farm with his mother based on an oral agreement with her.

Citing from *Emerson* and related decisions, the Court held that the remainder interest satisfied the ownership test. The creditor argued, citing authorities from other jurisdictions, including Wisconsin, that the remainder interest failed to satisfy the occupancy test because by law the right to legal possession remained with the life estate holder. The Court rejected this argument and held that the debtor's actual possession through oral agreement satisfied the occupancy requirement. *Citing Ryan v. Colburn*, 241 N.W. 388 (Minn. 1932) (holding that the debtor occupied a residence for the homestead statute even though the debtor violated state statute by failing to obtain a building permit).

In holding to protect the homestead, the Court stated the following:

> We are satisfied that in close cases like this one the test to be used in determining whether the house is 'owned and occupied' by the debtor should be whether the ownership and occupancy affords a community connection of such significance as to give reason to believe that the preservation of that connection will in the long run make the debtor and his family better able to fulfill their social obligation to be self-sustaining.

<u>NUMBER 7: *First Nat'l Bank of Mankato v. Wilson*</u>

Bankruptcy Relevancy: Abandonment of Homestead Exemption

In *First Nat'l Bank of Mankato v. Wilson*, 47 N.W.2d 764 (Minn. 1951), the Minnesota Supreme Court held that debtors who leased their homestead for a just under a year and did not record a notice of claim to retain their homestead within six months and abandoned their homestead interest.

The creditor obtained judgments against Mr. Wilson. Approximately ten months before the entry of the judgment, Wilson executed a one-year lease on their residence. In connection with the lease, Wilson sold the tenant most of the furnishings in the house. Wilson stored some additional property in the attic.

After entering the lease, Wilson moved to Texas during the winter where he had work as a temporary employee building roads. The Wilsons returned to Mankato the following spring and requested that their tenants vacate the lease early. The tenants declined, and the Wilsons purchased a new house nearby on a contract for deed. The Wilsons did not occupy the new house but lived in a trailer house in the backyard.

That summer, the Wilsons also re-titled their prior residence solely into Mrs. Wilson's name through two transfers using a third-party. At this time, the Wilsons also filed their notice to retain a homestead interest in the property, now nine months after executing the lease and moving to Texas.

The tenants vacated the Wilsons' former residence shortly before the expiration of the one-year lease, and the Wilsons re-occupied their old residence at that time. Shortly after re-entering their residence, the sheriff levied upon the property, and the creditor also obtained a fraudulent transfer judgment against Mrs. Wilson based on re-titling the property solely in her name.

The Supreme Court recognized several principles involving the sale or abandonment of homestead which persist today:

(1) that a debtor can sell a homestead and maintain an exemption on the proceeds for up to a year, *see* MINN. STAT. § 510.07;

(2) that a debtor's right to transfer a homestead is absolute and not subject to avoidance as a fraudulent conveyance, *see* MINN. STAT. § 513.41(2);

(3) that if a debtor "shall cease to occupy" a homestead for six consecutive months he or she "shall be deemed to abandon the same", unless he or she records a notice claiming that he yet intends to claim the property exempt, *see* MINN. STAT. § 510.07 (providing an effective notice will extend the exemption claim for five years).

The Court held that the circumstances showed that the debtors "ceased to occupy" the premises for nearly a year and that the failure to record this notice within six months was conclusive of abandonment. *Compare Lundgren v. Yde*, 213 N.W. 537 (Minn. 1927) (owner rented residence to two consecutive tenants but between the two leases regained the residence for a day to interrupt the six-month period).

Even though the Wilsons lost their homestead on this occasion, they followed the abandonment statute correctly the second time around, which led to the notable decision that debtors could exempt rents from a homestead so long they maintained the occupancy requirement. *Wilson v. First Nat'l Bank of Mankato*, 60 N.W.2d 69 (Minn. 1953).

One significant push-back against *Wilson* is that courts have also weighed the debtor's intent in the "cease to occupy" analysis, even though the Minnesota Supreme Court did not seem to credit such a factor. *See e.g., Estate of Riggle*, 654 N.W.2d 710 (Minn. App. 2002) (stating that abandonment has "two basic components: cessation of occupancy and lack of an intent to return"); *Accord In re Hickman*, 23 N.W.2d 593 (1946) (stating that "Abandonment of a homestead results when the owner removes therefrom and ceases to occupy the same, with the intention of never returning, or with no intention of returning thereto to reside"); *but see Muscala v. Wirtjes*, 310 N.W.2d 696 (Minn. 1981) (holding that the six-month vacancy rule "means that the homestead exemption is lost after 6 months unless the person has filed, no matter what the person's intention").

Abandonment has been probably the most frequently-litigated homestead issue in state and bankruptcy court. *See e.g., Vickery v. First Bank of LaCrosse*, 368 N.W.2d 758 (Minn. App. 1985), *rev. denied* (Minn. 1985) (holding the exemption is not abandoned where debtor has vacated for six months but the debtor's spouse has remained in occupancy); *Eustice v. Jewison*, 413 N.W.2d 114 (Minn. 1987) (holding that debtor's arrest and commitment to a mental institution did not constitute a cessation of occupancy as he was under a legal disability from occupying the home); *In re Mueller*, 215 B.R. 1018 (8th Cir. 1997) (holding that leaving the residence due to marital separation is not a legal disability that would exempt the debtor from the abandonment rule).

Even if a debtor files a notice of non-abandonment within six months, a creditor/trustee can still overcome the filing by showing an actual intent to abandon the property. *Cysewski v. Steingraber*, 24 N.W.2d 266 (Minn. 1946).

Related State Authorities Regarding Homestead Issues

Only one homestead exemption per family. *See* MINN. STAT. § 510.02, SUBD. 1; *In re Carlson*, 394 B.R. 491, 494 (B.A.P. 8th Cir. 2008).

The value of the homestead exemption is based on the amount of equity in the homestead, and not the mere value of the homestead. *Bauman v. Chaska Bldg. Ctr.*, 621 N.W.2d 795 (Minn. Ct. App. 2001).

If I Grow Pot On My Homestead, Can My Homestead Be Forfeited Under State Forfeiture Statutes?

Nope. Minnesota's criminal forfeiture statute, Minn. Stat. § 609.5311, subd. 2 (2004), may not constitutionally be applied to homestead property, as defined by law, because it permits the forfeiture of homestead property in satisfaction of the homestead owner's liability, as proscribed by Minn. Const. art. I, § 12. *Torgelson v. Real Property*, 734 N.W.2d 279 (Minn. App., 2007)

How do you establish that this really is your homestead?

a. The Ownership Test

Kelly v. Baker, 10 Minn. 154 (1865); *In re Emerson's Homestead*, 58 Minn. 450, 60 N.W. 23 (1894); *Fid. Philadelphia Trust Co. v. Brown*, 181 Minn. 392, 232 N.W. 740 (1930).

b. The Occupancy Test

The term "occupancy" within the homestead exemption statute means actual occupancy. *Quehl v. Peterson*, 47 Minn. 13 (1891). "To fulfill the actual occupancy requirement, a debtor does not need to have a constant physical presence, so as to make a man's residence his prison. Actual occupancy, however, requires more than an intent to occupy the property in the future." *Clark v. Dewey*, 73 N.W. 639, 639–40 (Minn. 1898).

c. The Physical Character Test

Although intended to protect the debtor's primary residence from creditors, the debtor may use the property for purposes other than as a dwelling. *In re Lockey's Estate*, 112 Minn. 512, 128 N.W. 833, 834 (1910). In fact, under Minnesota law, it is clear that the homestead is not limited to the dwelling and immediately surrounding land, "but extends to farmland and business-use property." *In re Estate of Riggle*, 654 N.W.2d 710, 716 (Minn. Ct. App. 2002) (citing *O'Brien v. Wilford & Patricia Johnson*, 275 Minn. 305, 148 N.W.2d 357, 361 (1967); *Stauning v. Crookston Mercantile Co*., 134 Minn. 478, 159 N.W. 788 (1916)). *See also Wilson v. First Nat'l Bank*, 239 Minn. 550, 60 N.W.2d 69, 70 (1953); *Rux v. Adam*, 143 Minn. 35, 172 N.W. 912 (Minn. 1919). A homestead may be comprised of more than one parcel. *Id*. The test to determine whether the multiple parcels may all qualify as the homestead was set forth as follows: "The essential thing to constitute a quantity of land within the homestead law is that it shall be occupied and cultivated as one piece or parcel of land, on some part of which is located the residence." *Brixius v. Remringer*, 101 Minn. 347, 349, 112 N.W. 273, 274 (1907). This object is accomplished where two parcels touch at the corners, provided the essential conditions to constitute a homestead exist. *Id*.

Under the *Brixius* test, the threshold factor is the proximity of the parcels, and it is irrelevant whether the parcels are consistently titled, encumbered differently, or acquired at separate times. *Riggle*, 654 N.W.2d at 717. Contiguousness of multiple parcels, although somewhat downplayed in *Brixius*, has been held in one Minnesota bankruptcy case to still be part of the analysis of whether the "dwelling place" is sufficiently "together with the land" to be considered one "homestead." *Michels v. Kozitza*, 610 N.W.2d 368 (Minn. Ct. App. 2000) (relying upon the lengthy historical precedent necessitating the contiguous nature of the property regardless of whether the need for the contiguity requirement for purposes of fulfilling the policy purposes was antiquated in the context of modern farming operations).

<u>NUMBER 6: *Victoria Elevator Co. of Minneapolis v. Meriden Grain Co., Inc.*</u>

Bankruptcy Relevancy: (1) Property of the Estate/Debtor; (2) Claims Disputes / Dischargeability; (3) Exemptions

In *Victoria Elevator Co. of Minneapolis v. Meriden Grain Co., Inc.*, 283 N.W.2d 509 (Minn. 1979), the Minnesota Supreme Court held that creditors could pierce a corporation's veil of limited liability to impose liability on a shareholder for the corporation's debts.

In *Victoria Elevator*, an individual had operated a seed business as a sole proprietor for ten years. He later incorporated the business but made only a small capital contribution and failed to transfer most of the property of the seed business into the corporation. Debtor and his wife continued to own the business property and did not charge rent to the corporation. The corporation yet listed these individual assets on various financial statements to obtain credit. The corporation also deducted expenses related to the property it did not own.

The corporation defaulted on its debts. It then transferred the property it did own to the shareholders thereby leaving the corporation without assets to pay its creditors. The corporation continued to pay funds to the individual debtors notwithstanding its financial distress. The shareholder also regularly input funds into the corporation as either loans or capital but also kept poor records of the transactions.

The Minnesota Supreme Court held that this conduct warranted disregarding the corporate veil, which requires a two-step process. First, the court must examine whether the shareholder failed to maintain the corporate form, considering: (1) insufficient capitalization; (2) failure to observe formalities; (3) nonpayment of dividends; (4) insolvency; (5) siphoning of funds to shareholders; (6) nonfunctioning of officers and directors; (7) absence of corporate records; (8) existence of corporation as merely a façade. Second, the court must find that the failure to maintain these forms caused injustice or fundamental unfairness.

The Minnesota Supreme Court further adopted the concept of "reverse-piercing" whereby an individual could claim exemptions in assets owned by a family farm corporation. *Cargill, Inc. v. Hedge*, 375 N.W.2d 477 (Minn. 1985); *State Bank in Eden Valley v. Euerle Farms, Inc.*, 441 N.W.2d 121 (Minn. App. 1989); *see also In re Hecker*, 414 B.R. 499, 503–05 (Bankr. D. Minn. 2009) (no reverse-piercing available to provide an exemption to an individual debtor whose home was actually owned by an entity controlled by the debtor).

A trustee does not have general standing to assert a veil piercing claim in a bankruptcy case, which is a remedy that belongs to creditors and does not pass to the trustee under § 544. *In re Schuster*, 132 B.R. 604 (Bankr. D. Minn. 1991), *citing In re Ozark Restaurant Equipment Co., Inc.*, 816 F.2d 1222 (8th Cir. 1987), *cert. den.*, 484 U.S. 848 (1987). Substantive consolidation is a possible alternative to the trustee.

A trustee of an individual debtor may be able to use reverse-veil piercing to bring the assets of a corporation owned by the debtor/shareholder. *Schuster*; *In re Burwell*, 391 B.R. 831 (BAP 8th Cir. 2008).

In *In re Lindell*, 334 B.R. 249 (Bankr. Minn. 2005), the bankruptcy court held that a note owing to the debtor's corporation was property of the individual debtor for allowing the individual debtor's trustee to seek avoidance of the transfer of the note.

Reverse veil-piercing applied in *Petters* to establish standing for a trustee in seeking an avoidance remedy under state law standards pursuant to § 544(b). *In re Petters Company, Inc.*, 561 B.R. 738 (Bankr. D. Minn. 2016).

NUMBER 5: *Snyder Electric Co. v. Fleming*

Bankruptcy Relevancy: Fraudulent Transfers and Fiduciary Duties to Creditors

In *Snyder Electric Co. v. Fleming*, 305 N.W.2d 863 (Minn. 1981), the Minnesota Supreme Court held directors and officers of a corporation cannot pay personal debts ahead of debts of creditors when the corporation is insolvent.

Two creditors obtained a judgment against a corporation and finding the corporation unable to satisfy the judgments then sued the president and sole shareholder of the corporation for: (1) fraudulent conveyances; (2) piercing the corporate veil; and (3) breaching his fiduciary duties to creditors of the corporation. The principal operated the debtor and two other controlled entities from the same premises. Money freely-flowed from the debtor and among the entities that the debtor accounted for through various intercompany ledgers. The entities would often pay each other's debts and salary obligations and provide services or sell items to one another. The principal routinely paid corporate obligations with his personal assets, and regularly put his earnings back into the businesses.

One of the three entities controlled by the principal was a café operated at the site, which continued operations successfully well-after the other two businesses failed. A fire later destroyed the café, and the judgment creditors sought collection of the fire insurance claim and property site.

The Court rejected the first two theories. First, even though transactions between an officer and the corporation are presumptively fraudulent, the principal showed "clear proof he acted with impartiality and fairness to the corporation" through business records accounting for the transactions between entities. These records showed each entity paid consideration for any transfers. Any transfers to the principal were in consideration for a debt he had with the corporation.

Second, the principal maintained sufficient corporate forms and bookkeeping records to maintain a corporate veil between the entities.

The Court held that the breach of fiduciary duty claim had merit. The Court held that an insolvent corporation cannot pay the debts of a principal to the detriment of other creditors. *Snyder Electric* is in effect a preference remedy, similar to MINN. STAT. § 514.45(b). The transactions cited by the Court that violated the principal's fiduciary duty included the principal taking assignment of the company's accounts receivable to repay debts to him. He also applied the sale of corporate assets to pay a business loan he had personally guaranteed.

The Minnesota Court of Appeals subsequently limited the duties in *Snyder Electric* to that of self-dealing to the detriment of other creditors. *St. James Capital Corp. v. Pallet Recycling Assoc. of N. Am.*, 589 N.W.2d 511, 517 (Minn. App. 1999).

A failure to maximize the value of assets in a winddown or liquidation is generally not a breach of duty *Id*. (stating "officers and directors of insolvent corporations are not obligated, as a matter of law, to liquidate their corporations for the benefit of unsecured creditors, but, can pursue risky restructuring plans in good faith attempts to regain solvency.)

It is not clear that *Snyder Electric* provides any direct claims for a trustee, as it is right of action running to the creditors of an entity. In *In re Bellanca Aircraft Corp.*, a trustee cited *Snyder Electric* as supporting authority to equitably subordinate the claims of insiders based on their receipt of preferences, a position rejected by the bankruptcy court and Eighth Circuit. 850 F.2d 1274 (8th Cir. 1988) (declining to "hold that receipt of a preference without more, is the type of inequitable conduct that warrants subordination of a claim").

One bankruptcy decision has similarly restricted breach of fiduciary duty in the zone of insolvency claims to self-dealing. *Security Asset Capital Corporation*, 390 B.R. 636 (Bankr. D. Minn. 2008) (concluding that a "breach of fiduciary duty by directors and officers is practically limited to their self-dealing to the detriment of their corporations, even in corporate insolvency").

The breach of fiduciary duty under *Snyder Electric* for self-dealing does not create a dischargeability issue. *In re Thompson*, 686 F.3d 940 (8th Cir. 2012) (holding that the common law duty to creditors does not rise to the level of a technical trust under § 523(a)(4)).

NUMBER 4: *J.F. Anderson Lumber Co. v. Myers*

Bankruptcy Relevancy: Whether to File Bankruptcy / Claims Allowance / Successor Liability

In *J.F. Anderson Lumber Co. v. Myers*, 206 N.W.2d 365 (Minn. 1974), the Minnesota Supreme Court set forth rules where a corporation receiving the transfer of substantially all the assets could become liable for the debtors of the transferor.

J.F. Anderson Lumber Co. arose from a residential remodeling project that went overbudget and resulted in a mechanic's lien claim and lawsuit involving a few subcontractors, the builder, the mortgagee and the owner. The owner obtained a judgment for excessive charges against the builder, Richard T. Leekley, Inc.

After the judgment, Mr. Leekley and his wife formed a new corporation called Leekley's, Inc. The new corporation performed the same residential construction and remodeling services, had received a transfer of the assets from the old corporation, hired three of its employees, and had the same shareholders. The old corporation became insolvent and stopped doing business but also did not transfer any incomplete jobs to the new corporation. The new corporation argued it was not liable for the debts of the old corporation. The corporations did not undertake any affirmatively fraudulent acts to conceal the transfers.

The owner attempted to garnish the assets of the successor entity, and the district court initially entered judgment for the owner/creditor. The Minnesota Supreme Court reversed. The Court held that where one corporation transfers its assets to another corporation, absent consolidation, merger, or a mere continuation of the selling corporation, such as a reorganization, the receiving corporation is not responsible for the debts of the transferring corporation except (a) where the purchaser agrees, expressly or impliedly, to assume such debts, or (b) the transfer of assets is entered into for inadequate consideration, or otherwise fraudulently, in order to escape liability for such debts.

The Court found that the record did not support successor liability. The mere fact that the successor entity is carrying-on the same business through a continuity of business, name, and management is not sufficient. The new corporation did pay consideration to the old corporation for assets. The Court suggested that where the transferring corporation may have a goodwill value associated with a common principle of the transferee corporation, that could constitute an opportunity to argue lack of consideration, but no such good will was established in this case. The motivation of the transfers could be avoiding the payment of the transferor's debts, but motive alone is not sufficient to impose successor liability absent other fraudulent conduct or lack of consideration.

Successor liability is barely distinguishable from a fraudulent transfer claim, except that in a successful claim the successor may become liable for the entire debt, not just the value of the transferred asset.

The legislature codified *J.F. Anderson* by enacting MINN. STAT. § 302A.661, and after further amendments, this section presently states:

> **Subd. 4.Transferee liability.**
>
> The transferee is liable for the debts, obligations, and liabilities of the transferor only to the extent provided in the contract or agreement between the transferee and the transferor or to the extent provided by this chapter or other statutes of this state. A disposition of all or substantially all of a corporation's property and assets under this section is not considered to be a merger or a de facto merger pursuant to this chapter or otherwise. The transferee shall not be liable solely because it is deemed to be a continuation of the transferor.

The legislature added the last sentence due to arguments raised in some cases to expand the mere continuation test beyond a formal reorganization situation. *See Niccum v. Hydra Tool Corp.*, 438 N.W. 96, 98 (Minn. 1989) (denying expansion of the mere continuation test but cited as opening the door for an expanded test). Courts had developed the *de facto* merger test that held that successor liability could apply in considering the following four factors: (1) continuity of management, personnel, assets and operations; (2) continuity of shareholders; (3) the seller ceased operations and dissolved as soon as legally possible; (4) the purchaser assumed the obligations of the seller necessary for uninterrupted continuation of business operations. *T.H.S. Northstar Assocs. v. W.R. Grace & Co.-Conn.*, 840 F.Supp. 676 (D. Minn. 1993).

The LLC statute also adopted a near-identical provision as to successor liability, *see* MINN. STAT. § 322B.77. When the legislature revamped the LLC statute in Chapter 322C, it does not appear it carried-over the successor liability provision from its predecessor. The *de facto* merger limitation as to corporations also does not apply to non-profit corporations. *Hankinson v. King,* 117 F.Supp.3d 1068 (D. Minn. 2015).

<u>NUMBER 3: *Finn v. Alliance Bank*</u>

Bankruptcy Relevancy: Fraudulent Transfers Based on Minnesota Law

In *Finn v. Alliance Bank,* 860 N.W.2d 638 (Minn. 2015), the Minnesota Supreme Court held that Minnesota's version of the Uniform Fraudulent Transfer Act (MUFTA) did not contain a Ponzi scheme presumption. Moreover, payments made during a Ponzi scheme for repayment of contractual debt were supported by reasonably equivalent value. The Court further held that claims for actual fraudulent transfer imposed a six-years statute of limitation that ran from discovery of the fraud.

Finn involved a Ponzi scheme whereby First United Funding (FU Funding) oversold some loan participations to various community banks exceeding the amount of the underlying loans originated by the broker. FU Funding also sold a handful of participations for loans that did not exist. Despite the presence of fraudulent activity, many participation interests derived from non-fraudulent loans. The Feds yet convicted the principal of FU Funding of bank and tax fraud.

The banks successfully sought appointment of a state court receiver. The receiver pursued certain banks under MUFTA for the recovery of false profits in the form of interest income generated from the Ponzi scheme. The banks argued that they had simply received payment of contractual interest under the participation agreements.

The Supreme Court held that the repayment of contractual debt was not a fraudulent transfer simply because FU Funding made the payments as part of a Ponzi scheme. MUFTA does not contain a Ponzi Scheme presumption, though it may constitute a circumstance of fraud similar to other enumerated badges. But the Court reiterated that no one badge was determinative and thus it "precludes" the determination that the legislature "intended a *non-enumerated* badge of fraud to be *conclusive*."

The Court also found that the existence of the Ponzi scheme did not automatically mean that contractual payments under the participation agreements did not constitute reasonably equivalent value or conclusively establish that the debtor was even insolvent.

In rejecting the presumption, the Minnesota Supreme Court diverged from what appeared to be the majority rule. The ruling became a significant development in ongoing Ponzi scheme cases in state and federal courts. Several parties engaged in the *Petters* bankruptcy case submitted *amici curiae* briefs in *Finn*.

The Supreme Court further reaffirmed its prior precedent that claims to avoid transfers based on actual fraud are subject to a six-year statute of limitations with a discovery allowance as “claims for relief on the ground of fraud.” The Court rejected the argument that such claims arose “upon a liability created by statute” which had a six-year limitations period without a discovery allowance. The Court did not rule on the statute of limitations applicable to constructive fraud claims.

In a broad way, *Finn* also shows that Minnesota law has a tendency to allow less clawbacks in hindsight later than will federal courts. An excellent deconstruction of just what *Finn* did, how it did it and what is might mean in future state and federal cases is found in one of the three Magnum Opus decisions of Judge Kishel in the *Petters* case. *See, Kelley, et. al. v. Opportunity Finance, LLC et. al., (In re: Petters Company, Inc., et al.)* 550 B.R. 457 (Bankr. Minn. (Kishel) 2016).

One other potential outcome of *Finn* is its impact on other presumptions that courts have applied with respect to a fraudulent transfer claims. Minnesota has recognized a spousal presumption which presumes that all transfers between spouses are fraudulent unless the spouse showed fair consideration by clear and convincing evidence. *Minneapolis Stock-Yards & Packing Co. v. Halonen,* 57 N.W. 1135 (Minn. 1894) (holding that “where a judgment is upon a claim which accrued prior to a conveyance to his wife of property belonging to the debtor husband, which property the creditors are trying to reach, the burden of proof is upon the wife to show the purchase by clear and convincing evidence, and that it was for valuable consideration”).

Applying the marital presumption again permits a creditor to bypass several requirements under actual and constructive fraud and shifts the burden of proof to the defendant. Under the spousal presumption, a transferor could be solvent for instance, and the transfer still avoided.

One year prior to *Finn*, the Minnesota Supreme Court declined to rule as to whether the marital presumption remained a rule of law under MUFTA and further stated that by the statute “insider” status would only constitute one badge of fraud. *Citizens State Bank Norwood Young America v. Brown*, 849 N.W.2d 55 (Minn. 2014). The Court though found the debtor was not married at the time of the transfer and therefore did not see a basis to apply the presumption. *Finn’s* subsequent holding regarding presumptions further calls the marital presumption into question.

NUMBER 2: *Medill v. State of Minnesota*

Bankruptcy Relevancy: Exemptions

In *Medill v. State of Minnesota,* 477 N.W.2d 703 (Minn. 1991), the Minnesota Supreme Court held that Minnesota’s exemption for “rights of acts for injuries of the person of the debtor or of a relative” was Constitutional as applied to an award of general damages and future special damages.

In 1984, Mrs. Medill suffered significant injuries from an automobile accident. The trial court awarded Mrs. Medill general damages of $67,500 and future special damages for future medical care of $6,300. The court awarded damages to Mr. Medill for loss of consortium in the amount of $3,000.

The Medills later filed for bankruptcy and claimed 100 percent of the right of action arising from those injuries as exempt under MINN. STAT. 550.37, subd. 22 (1990). The trustee objected to the exemption as constituting an unlimited exemption that violated Article I, Section 12 of Minnesota Constitution which provides that only a "reasonable amount of property shall be exempt." The bankruptcy court agreed with the trustee, but on appeal the district court certified the question to the Minnesota Supreme Court.

The trustee argued it was a simple case because the statute provided no monetary limitation. The Minnesota Supreme Court rejected this argument and stated that exemptions could be constitutional even without an expressed dollar limitation on their face. In such cases, the legislature did not have the sole responsibility in determining an exemption and could "assign to the judicial process the role of determining 'a reasonable amount' of a personal injury right of action exemption."

Further, the statute set the personal injury amount based on "objective criteria" because it would be limited in each case by the general damages awarded in the personal injury action or by an out-of-court settlement. It would be "impossible and ludicrous" for the legislature to impose determine a "reasonable amount" for a personal injury action across the board.

Medill was the final case in a trilogy of Minnesota Supreme Court cases certified from bankruptcy proceedings deciding the Constitutionally of exemptions that lacked set dollar amounts in cases. *See In re Tveten*, 402 N.W.2d 551 (Minn. 1987) (holding that exemptions for annuities and unmatured life insurance from a fraternal benefit society unconstitutional since they granted a "value limitless exemption"); *In re Haggerty*, 448 N.W.2d 363 (Minn. 1989) (holding that pre-value homestead exemption was constitutional because it had "reasonable limits in the form of area limits").

The Minnesota Supreme Court also subsequently ruled that any exemption limited by the amount "to the extent reasonably necessary" to the debtor creates a sufficiently objective test to withstand constitutional scrutiny. *Estate of Jones by Blume v. Kvamme*, 529 N.W.2d 335 (Minn. 1995).

Related bankruptcy caselaw clarified the rules of personal injury exemptions. As provided in *In re Cook*, 138 B.R. 943 (Bankr. D. Minn. 1992), issued after *Medill*, general damages and post-petition special damages are exempt, but pre-petition special damages, and punitive damages are not exempt. *See also In re Bailey*, 84 B.R. 608 (Bankr. D. Minn. 1988).

As stated in *Cook*, "[g]eneral damages include: temporary or permanent physical and mental loss or impairment, including future earning capacity; pain or suffering, including that reasonably certain to occur in the future; mental suffering, including that to occur in the future; and future medical costs reasonably certain to occur." *Id*.

Special damages include: "existing medical costs; actual lost income; existing non-medical costs and expenses; and property lost, damaged or destroyed in the incident that caused the injury." *Id.* Special damages seek to "reimburse the injured party for the actual economic loss incurred as a direct result of the incident that caused the injury." *Id.*

NUMBER 1: *In re Tveten*

Bankruptcy Relevancy: Exemptions and Pre-Bankruptcy Planning

In *In re Tveten*, 402 N.W.2d 551 (Minn. 1987), the Minnesota Supreme Court held that debtors could convert non-exempt property into exempt property so long as such transfers did not constitute fraudulent transfers under Minnesota law.

In *Tveten*, a debtor filed chapter 11 bankruptcy claiming $18.92 million in liabilities and only $2 million in assets. Of these assets, the debtor claimed approximately $775,000 in exempt annuities and unmatured life insurance policies purchased from the Lutheran Brotherhood, a fraternal benefit society. The debtor invested in these exempt assets within four months before filing bankruptcy by using various sources of non-exempt assets, including cash from the sale of real property, salary and other income from his checking account, retirement plan and a profit-sharing plan.

Creditors objected to the exemptions, and the bankruptcy certified four questions of Minnesota law to the Minnesota Supreme Court. The Minnesota Supreme Court held that the debtor's interest in and right to receive payments from the annuities and unmatured life insurance policies constituted exempt property under MINN. STAT. §§ 550.37, subd. 11 and 64B.18. The Court, however, further held that such provisions were unconstitutional because they granted a "value limitless exemption." The Court could not find them Constitutional by simply imputing a reasonableness element.

The text of § 550.37 remains unchanged since *Tveten* and exempts "all money, relief, or other benefits payable or to be rendered by any police department association, fire department association, beneficiary association, or fraternal benefit association to any person entitled to assistance therefrom, or to any certificate holder thereof or beneficiary under any such certificate." Section 64B.18 similarly provides that any such benefits are not subject to attachment or garnishment.

Finally, the Court held that it was permissible under Minnesota law to convert exempt property into non-exempt property unless extrinsic circumstances of fraud existed beyond the mere conversion of assets to show that the debtor intended the conversion of assets to defraud his or her creditors.

Tveten does not draw the line as between permissible pre-bankruptcy planning and impermissible planning, but merely says there is a line. The line between fraudulent intent and allowable "exemption planning" is grey. Minnesota case law recognizes that debtors can take advantage of all available exemptions. If a debtor was not allowed to "fill up" on exemptions, then the list of exemptions would be nothing but a list of assets protected by accident at the time of bankruptcy. In *Tveten,* the Minnesota Supreme Court proclaimed, "It is a right which the law gives [the debtor], subject to which everyone gives him credit, and fraud can never be predicated on an act which the law permits."

The bankruptcy courts seized upon the potential of impermissible planning to deny both exemptions and discharge if enough extrinsic badges of fraud exist to show a fraudulent intent. The most recent example in this line of cases is *In re Addison*, another case that ultimately resulted favorably to the debtor.

<u>Related State Authorities Regarding Exemptions</u>

Exemptions should be liberally construed.

Lahti v. Peterson, 175 Minn. 389, 392, 221 N.W. 534, 535 (1928) (recognizing that the homestead exemption should be liberally construed).

Interaction Between State Laws And Case Law

Beware of cases that have been overruled by subsequent acts of the legislature. Taxing authorities may levy on exempt property absent a bankruptcy filing. 11 U.S.C. § 522(c)(1). Under *In re Bame*, 271 B.R. 354 (Bankr. D. Minn. 2001), the bankruptcy court correctly noted that under Minnesota Statutes section 270.69, subdivision 10 (2001), state taxing authorities could not execute on a debtor's homestead unless the equity in that homestead exceeded the statutory limit for exempt homestead property. However, that case has been essentially overruled by the state legislature through the repeal of section 270.69 in 2005. 2005 Minn. Laws ch. 151, art. 1, § 117.

And, conversely, beware of state statutes still on the books that have been overruled by the courts. Minnesota Statutes section 550.371 was enacted in 1982. The statute waded into the controversy that then existed about whether under 11 USC § 522(b) when a joint petition was filed whether the two spouses could use different exemption schemes. Minn.Stat. § 550.371, subd. 2 declares (still) that all married couples filing a joint bankruptcy must choose either state or federal exemptions. In 1984 that provision was invalidated under the Supremacy Clause. *In re Soby*, 37 B.R. 522, 525 (Bankr. D. Minn. 1984). In 1984 the federal bankruptcy code was clarified in the same way, it was now definite that married couples filing joint bankruptcy must use the same set of exemptions (either federal or Minnesota) when filing a joint petition. 11 U.S.C. §§ 302 & 522(b). If the joint debtors cannot agree as to which set of exemptions to use, the federal exemptions will apply. 11 U.S.C. § 522(b)(1). However, Minnesota Statutes 550.371 subd. 3 provides that if one spouse files an individual bankruptcy and chooses one set of exemptions, the other spouse must use the same set of exemptions if they file bankruptcy within three years of the first spouses' petition. MINN. STAT. § 550.371, SUBD. 3. The *Soby* ruling is now perhaps moot, because the code was changed in 1984 to clearly align the intent of the federal law to match the state choice-of-exemptions law. Query, however, whether Minnesota's attempt in section 550.371, subdivision 3 to limit one spouse's choice of exemptions if they file within three years of the other spouse's petition would still be unconstitutional under the Supremacy Clause, as the *Soby* court found with regard to subdivision 2.

Personal Injury Proceeds:

Proceeds of personal injury, as opposed to the cause of action leading to the payment, are not exempt under Minn. Stat. 550.37 subd. 22. *Midland Credit Mgmt. v.*

Chatman, 796 N.W.2d 534 (Minn. App., 2011). Bankruptcy courts have come to the same conclusion.

Unlimited Exemptions

Minnesota's exemption for "one watch" and perhaps even the other unlimited exemptions in Minnesota Statutes section 550.37, subdivision 4(a) and (b) (for "utensils" or "wearing apparel") may be unconstitutional under a long line of cases interpreting article I, section 12 of the Minnesota Constitution. Those cases have held that only a "reasonable" amount of property can be claimed exempt under Minnesota law. *Estate of Jones by Blume v. Kvamme*, 529 N.W.2d 335 (Minn. 1995); *In re Tveten*, 402 N.W.2d 551 (Minn. 1987); *In re Haggerty*, 448 N.W.2d 363 (Minn. 1989); *Medill v. State*, 477 N.W.2d 703 (Minn. 1991). In *Haggerty*, the Minnesota Supreme Court said, "an exemption with a dollar, an objective, or a statutory 'to the extent reasonably necessary' limit is a proper legislative determination of reasonableness." 448 N.W.2d at 366.

Wedding Rings under State Law

When an engaged debtor, in possession of an engagement ring at the time of filing, subsequently calls off the wedding, the ring is not property of the bankruptcy estate. The ring is a conditional gift, and the bankruptcy code does not oblige the debtor to go through with the wedding. *Benassi v. Back & Neck Pain Clinic, Inc.*, 629 N.W.2d 475 (Minn. Ct. App. 2001).

Inherited IRAs

Minnesota provides for an IRA exemption. MINN. STAT. § 550.37, SUBD. 24(a). This section also applies to those IRAs funded via an inheritance from a family member *See Russell's AmericInn, LLC v. Eagle Gen. Contractors, LLC*, 772 N.W.2d 81, 83–85 (Minn. Ct. App. 2009). However, under bankruptcy law, the United States Supreme Court in *Clark v. Rameker*, 134 S. Ct. 2242 (2014) decided that inherited IRAs are not "retirement funds" under 11 U.S.C. § 522(b)(3)(C), thus reversing an Eighth Circuit BAP opinion on the same subject, *In re Nessa*, 426 B.R. 312, 315 (B.A.P. 8th Cir. 2010). It remains to be seen whether a debtor choosing state law exemptions can protect an inherited IRA up to the applicable limit of Minnesota Statutes section 550.37, subdivision 24 (currently $69,000) under 11 U.S.C. § 522(b)(3)(A), or whether the more specific provisions of 11 U.S.C. § 522(b)(3)(C), which allows those debtors choosing state exemptions to protect their "retirement funds" up to the limits of 11 U.S.C. § 522(n), preempts Minnesota law as to all inherited IRA funds.

How would a Minnesota Court decide whether an object is an exempt piece of personal property?

Minnesota Exemptions categories: "Personal Goods" is the category in Minn. Stat, § 550.37, subd. 4., but the "miscellaneous" category is actually "household appliances" not "household goods." What difference does this make?

Subd. 4.**Personal goods.**

(a) All wearing apparel, one watch, utensils, and foodstuffs of the debtor and the debtor's family.

(b) Household furniture, household appliances, phonographs, radio and television receivers of the debtor and the debtor's family, not exceeding $10,350 in value.

For instance, why, a client recently asked, aren't guns exempt personal property?

The question is not really whether a gun is a "personal good" but whether it is a "household appliance." *In re Irwin*, 232 B.R. 151, 153 (Bankr. D. Minn. 1999). This question has never been the subject of a reported court case. That is because, I suspect, that all responsible bankruptcy attorneys realize that a gun is not a household appliance. To go a little deeper into the legal precedent, the issue of whether something is protected under that statute is whether the item protects a "fundamental need." *In re Irwin*, 232 BR 131, (Minn. Bankr. 1999). The Minnesota Supreme Court has noted that Minnesota's exemption provisions, like those of every state, are designed to protect a debtor's fundamental needs by limiting the assets available to creditors. *Medill v. State*, 477 N.W.2d 703, 708 (Minn. 1991). The court further stated: "The humane and enlightened purpose of an exemption is to protect a debtor and his family against absolute want by allowing them out of his property some reasonable means of support and education and the maintenance of the decencies of life." *Id.* (quoting *Poznanovic v. Maki*, 209 Minn. 379, 296 N.W. 415, 417 (1941)).

Just What is "Public Assistance" anyway?

Minnesota Statutes section 550.37, subdivision 14 lists which public assistance programs are eligible for the exemption. There are many state and federal tax credits that come and go that are available to those who make under a certain amount of income. Many have not yet been put before a bankruptcy court for determination of their status as "public assistance." An unpublished Minnesota Court of Appeals opinion said that the list of programs in 550.37, subdivision 14 was to "provide direct payments or subsidies to address the basic economic needs of low-income recipients." *Burns v. Einess, No. 62-CV-10-11323, 2011 Minn. App. Unpub.* ***LEXIS*** 1013, 2011 WL 5829323 (Minn. Ct. App. 2011)). There is, therefore no bright line, but any debtor attempting to define a particular tax credit or refund as exempt under an applicable "public assistance" exemption statute may have to convince a judge that the program addresses a basic economic need, that it is offered to only low-income recipients. There are several bankruptcy courts opining on what is and is not "public assistance" but the Minnesota Supreme Court has not ruled definitively on the definition of "public assistance."

SESSION 403

Mobile Device Cyber Security for Bankruptcy Lawyers

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Mobile Device Cybersecurity for Bankruptcy Lawyers

Check List

John J. Carney, Esq.

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Maintain Physical Control of Your Device at All Times

Use Strong, Complex Pass Phrases
- A long, ten to fifteen character alphanumeric password is best
- Four or six digit password is not enough
- Four or five words and/or numbers separated by spaces are good pass phrases
- Titles of favorite movies, songs, plays, books, etc. are easy to remember

Use Automatic Lock Settings
- Set “auto-lock” for a short period of time (60 seconds or less)
- Set device lock after reasonable number of failed unlock attempts (10 to 15)

Disable Wi-Fi, Bluetooth, and NFC Settings When Not in Use
- Do not connect to unsafe devices around you
- Connect to Wi-Fi only at work or home and Bluetooth only in automobile or home, etc.

Eliminate Use of Public Wi-Fi Hotspots
- Disable Wi-Fi setting at Starbucks, hotels, etc.
- Use personal mobile hotspot (3G/4G) on your phone instead, but it’s expensive
- Or, use Virtual Private Network (VPN) third party service on your phone
- Consider NordVPN, which protects six devices at same time anywhere and inexpensively

Protect Office and Home Wi-Fi
- Use WPA2 authentication password on your office and home routers
- Update your office and home routers’ firmware regularly
- Consider Virtual Private Network (VPN) third party service for your routers

Encrypt Your Mobile Device
- Encrypt your Android phone, if not encrypted already by default, and all microSD cards
- Charge power to 80% and connect your Android phone to power when you encrypt it
- Your iPhone is encrypted already by default, but your iTunes backups are not

Use and Regularly Test Mobile Device Tools for Loss or Theft
- Enable remote location, ring, lock, and erase services for lost mobile device
- Set up and use Find My iPhone app on iCloud account to find your iPhone
- Set up and use Find My Device app (Android Device Mgr.) on Google account
- Consider third party mobile apps like Lookout, Cerberus, Lost Android, etc.
- Put first name and contact info on lock screen for use by person finding your phone

Upgrade and Patch Mobile Device Operating Systems
- Upgrade to new operating system version immediately
- Connect your mobile device to power during upgrade and use safe Wi-Fi signal

Choose and Install Mobile Malware Protection

Detect and remove viruses, spyware, and exploits like ransomware, etc.
Protect against drive-by download attacks for safe web surfing
Consider Trend Micro, FortiClient, Lookout, etc. for iPhone
Consider Malwarebytes, FortiClient, Trend Micro, Lookout, etc. for Android

Beware Mobile Social Engineering Scams

Be alert for personalized, targeted spear phishing attacks in your web mail or e-mail apps
Be alert for SMiShing attacks (“SMS phishing”) in your text messages
Both are clickjacking attacks that trick you into clicking on a harmful link or attachment

Do Not Jailbreak Your iPhone or Root Your Android Phone

Compromises vendor security controls and weakens your phone’s security

Protect USB Port

Use new USB restrictions on iPhone by disabling USB Accessories setting
Disable USB Debugging mode on Android Developer Options menu

Choose and Install Password Manager

It creates strong, complex passwords, automatically logs you in, reduces password reuse
Consider third party options like Dashlane, LastPass, eWallet, Apple’s iCloud Keychain

Enable Two-Factor Authentication (2FA)

It is a second, time-based password for secure access to web accounts and mobile apps
Protect your Google, iCloud, Apple ID and password manager accounts at a minimum
Use Google Authenticator or Authy app on phone to get time-based passwords
Or, more conveniently use your own YubiKey (USB security key)

Backup Your Mobile Device

Check your iCloud settings on your iPhone and set to backup and synch to the cloud
Check your Google settings on your iPhone or Android and set to backup to the cloud
Consider Android backups to cloud with third party apps (Lookout, Helium, etc.)
Backup your iPhone to Windows PC or MacBook and encrypt it with Apple’s iTunes

Mobile App Store Validity

Only download apps from Apple App Store for your iPhone
Only download apps from Google Play Store or Amazon Appstore for your Android
Do not enable Unknown Sources setting on your Android phone

Install Secure (Encrypted) Mobile Messaging Apps

Consider Signal, WhatsApp, and Google Allo
Consider TigerText for HIPAA compliant needs

Be Aware of Mobile Obfuscation

Spoliation by wiping phone remotely or resetting to factory conditions in settings
Spoliation by using third party “cleaner” apps
Use of hidden, password protected apps with vaults to hide documents, photos, or apps
Use of apps like AppLock to lock apps, settings, photo gallery, messages, etc.

Other Resources

Check the FCC’s Smartphone Security Checker @ www.fcc.gov/smartphone-security
Ten customized steps to secure your iPhone, Android, Windows Phone, or BlackBerry